UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF NEW YORK

Case No. 08-13555-scc

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In the Matter of:

LEHMAN BROTHERS HOLDINGS INC.,

Debtor.

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U.S. Bankruptcy Court

One Bowling Green

New York, NY 10004

January 30, 2017

10:05 AM

B E F O R E :

HON SHELLEY C. CHAPMAN

U.S. BANKRUPTCY JUDGE

ECRO: TB

Hearing re: Trial on Lehman's Objection to Claims of QVT (Doc # 17468 Debtors' One Hundred Fifty-Fifth Omnibus Objection to Claims)

Transcribed by: Sonya Ledanski Hyde

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P R O C E E D I N G S

THE COURT: Please, have a seat. How is everyone?

MAN 1: Very well, thank you.

THE COURT: Okay. Any -- anything I need to know before we get going? Anything in the nature of housekeeping? I trust your accommodations are satisfactory? All good? Okay. So, I understand -- yes, Mr. Tracey?

MR. TRACEY: Yes, they're palatial, compared to what we're used to, so thank you.

THE COURT: You're welcome. You're welcome, anytime. The price is right. It only cost a couple of ten million dollars to litigate and you can have a free room at the Bankruptcy Court for a while.

(LAUGHTER IN THE COURTROOM)

MR. TRACEY: I think the only housekeeping issue is something that we communicated to the Court --

THE COURT: About the motions in limity?

MR. TRACEY: Right, that's it.

THE COURT: All right, I'm ready. Let me just put some of this on my cart back here, and we'll be ready to go. The only party I have dialed in on the phone is Mr. Sanjana from Reorg Research. All right, so Mr. Tracey, you're up first, yes?

MR. TRACEY: Fine with me.

THE COURT: You only have two, right? Which is

the other PCS and card counterparty trades and the valuation of the side pocket, right?

MR. TRACEY: That's correct, Your Honor.

THE COURT: Okay, is there anything that you wanted to say in addition to what's in the papers, which I read?

MR. TRACEY: I have a few comments --

THE COURT: Sure.

MR. TRACEY: -- if you don’t mind, Your Honor?

THE COURT: No problem.

MR. TRACEY: Let me start with the counterparty motion. As Your Honor knows, we're moving to preclude Lehman from introducing evidence of the claims that were submitted by counterparties other than QVT.

THE COURT: Right.

MR. TRACEY: And there are really two grounds for the motion. The first is that to us, it's a complete sideshow to go into the valuations that other counterparties made of their positions under their circumstances, under an ISDA the provides for a party to value its positions based on its own situation and its circumstances. And to do that, to go down that road, we would have to litigate every one of those valuations. We would have to understand what the basis for the valuation was, what they considered, whether they made mistakes, and what affected the levels at which

they made their claims. We don't think that's a good use of time. We think that's a complete distraction, and we don't think it'll advance the ball at all.

But probably more importantly, this is a subject on which we have gotten no discovery and from the outset of this case, Lehman has taken the position that other counterparties' claims and resolutions are irrelevant to this case. So, from the -- in their -- I just -- let me read to Your Honor from Lehman's responses at objections to QVT's first request for production of documents. Right out of the box, Paragraph 5: "Lehman objects to each and all of the requests as overbroad to the extent that they seek documents or information relating to transactions or claims between Lehman or any of its affiliates and counterparties other than QVT." Period. And that theme, of course, was continued throughout all of the responses that we got, and so, we requested the information on -- as discovery to determine whether it was relevant, and they completely shut us down.

THE COURT: Did it make its way to any of our conferences? I just can't recall.

MR. TRACEY: Not really, Your Honor, because they took the position it wasn't relevant and we said, okay, if it's not relevant and you're not going to present evidence at trial on it, that's fine. We just didn't want to fight

it --

THE COURT: Okay.

MR. TRACEY: -- and extend things, and then, at a 30(b)6 deposition, the night before, we got a list of other counterparty claims in PCDS and CDS, and they said --

THE COURT: 30(b)6, a Lehman 30(b)6?

MR. TRACEY: A Lehman 30(b)6. So, long after they took this position, the night before, they said here's a document, and lo and behold, it includes very limited information about claims made by other PCDS and card parties, just really the amount -- the notional amount, the claim, the product and maybe a couple of other pieces of information, but absolutely no information about how those numbers were arrived at, whether they were based on the same methodology we used, a different methodology, whether they were correct or incorrect, what percentage of the claims it represented. So, it may be that somebody would put in a claim and not put much effort into it because it's a very small part of their claim. So, in order to make any comparison between where QVT made their claim and where another party made their claim, we would have to understand a lot more, and we don't have it, and I think it's too late to get it. They've taken their position and we believe they should (indiscernible).

THE COURT: All right, thank you. All right, why

don’t we do them one at a time?

MR. TRACEY: Okay. Thank you.

THE COURT: Yes?

MS. DEL MEDICO: Good morning, Your Honor.

THE COURT: Good morning.

MS. DEL MEDICO: I'm Jennifer Del Medico. I'm from Jones Day.

THE COURT: Yes.

MS. DEL MEDICO: Just wanted to make a few comments on what Mr. Tracey said. First of all, what Mr. Tracey was talking about was Lehman's position on whether or not Lehman was going to produce documents on how Lehman acted with respect to other counterparties.

THE COURT: Hold on. Say that again, please?

MS. DEL MEDICO: Sure. What Mr. Tracey was talking about was, Lehman was not going to produce documents showing how Lehman reacted with -- vis-à-vis to other counterparties. But what Lehman did produce, Your Honor, is a spreadsheet that showed information about other PCDS and CV -- and card counterparties.

THE COURT: So, the information that you're referencing is the information that Mr. Tracey identified as having been produced in connection with the 30(b)6 witness?

MS. DEL MEDICO: Correct. And --

THE COURT: Okay, but, Lehman did not produce --

all you're talking about is claims that were filed by Lehman-facing counterparties other than QVT, where the underlying trades were either PCDS or card?

MS. DEL MEDICO: Correct.

THE COURT: Okay. And -- but you did not -- but -- okay, keep going.

MS. DEL MEDICO: Okay, so, we produced a large spreadsheet showing what kind of -- what claims were given by other PCDS and card counterparties. Not only that, we produced the DQ information, so where available, they got the ISDAs, they got the termination notices, they got the claimant --

THE COURT: You mean MQ?

MS. DEL MEDICO: No, DQ.

THE COURT: Oh, the derivatives questionnaire.

MS. DEL MEDICO: I'm sorry, the DQ data.

THE COURT: Okay.

MS. DEL MEDICO: So, they have -- so, to say they have no data about other card counterparties is just -- it's not true. They do have data about other counterparties, and it was produced long --

THE COURT: What's the purpose -- how are you going to use this?

MS. DEL MEDICO: Sure. Well, okay, so QVT makes some statements in its brief. It says, we didn’t -- we

admit, we didn’t get market quotations for certain products, but you know what? It was highly unlikely that we would have gotten market quotations.

THE COURT: Right.

MS. DEL MEDICO: And so, we have evidence that, in fact, other counterparties went out and got market quotations (indiscernible).

THE COURT: Okay, so this is exactly where I wanted to go. So, there's a difference between saying, here's how another party valued its card exposure or its PCDS exposure, and that sheds light on whether or not what QVT did was reasonable or not, okay? That you can't do because I think Mr. Tracey has it exactly right. The number that another counterparty puts down on its claim is not probative of whether or not what QVT did was reasonable and consistent under the ISDA. To the extent that, however, you're talking about data that happens to have been uploaded into these claims and you want to use that data as evidence to test the position that there was or was not a market that the securities were or were not illiquid, I think that's a different thing.

So, now I can't tell if we have a dispute or not because they -- QVT needs to have had the opportunity to test that and understand it, and to the extent that -- and there was a -- I have managed to read virtually all of the

expert reports. To the extent that any one or more of the experts relied on data or the absence of data on the issues of market quotation, liquidity, et cetera, then that's relevant, and I would expect that that would have been identified as reliance materials, et cetera. So, on the point of, look at what these counterparties valued their positions at, that's not -- that cannot come in as being probative of what the level at which QVT values its positions. In terms of the underlying data, I hope the answer is that they've had access to that and have been able to test that. So, am --

MR. TRACEY: May I just --

THE COURT: And I'm going to tell you folks generally, notwithstanding the fact that I've done a lot of preparation, there's obviously a learning curve. So, to the extent that you hear me misstate something, please don’t hesitate to tell me and to -- and help me get a course correction if you think that I'm getting it wrong.

MS. DEL MEDICO: So, Your Honor, one of the other assertions QVT makes is, well, we're unique. There's no other PCDS counterparty like us because we have such a large position. And one of our experts is saying, you know, looking at the data, which they have and saying, you know, that's not true. They're not unique. There's another company that has more.

THE COURT: But that's -- but that's okay. That's not, look at these claims and they were -- and look at where their marks were and look at what day they valued them on. I'm -- you know, all the different factors, and using that kind of configuration as a means of comparing to QVT and saying, and therefore, what QVT did was not reasonable. You're again talking about underlying data. For example -- well, I won't give an example, right? So, let me go back to Mr. Tracey. Do we have a disagreement now?

MR. TRACEY: I don't think we do, Your Honor. There are several instances in which, during the course of discovery, Lehman produced information from other counterparties, which has now formed the basis of the opinions of both sides' experts. So, for example, there was a market quotation -- a successful market quotation for the card product by another counterparty. That was produced to us. We had no objection to that. So, both sides have now looked at that and said, okay, what does that tell us about the value of cards?

THE COURT: Sure.

MR. TRACEY: And so, we've incorporated that into our expert reports and we're prepared to put on evidence of it. So, to the extent that underlying market information was provided in discovery, we have no objection to using it at the trial.

THE COURT: Okay, well, those are the parameters, and we'll just have to keep that -- keep them in mind and see what happens. All right?

MS. DEL MEDICO: Just --

THE COURT: Yes?

MS. DEL MEDICO: -- just to be clear on one point, though, I -- we have -- we do have an expert and I want to make sure that Mr. Tracey is not talking about this type of data, who bases an opinion on data that we gave to QVT and he shows a scatterplot of, you know, where QVT's claim is compared to similarly situated parties, and that type of data, looking at what a similarly situated party does, courts routinely look at that type of data to assess whether a party is reasonable, and I want to make sure that that -- that that’s not outside of what you're talking about.

MR. TRACEY: That's precisely --

THE COURT: That's precisely what's outside --

MR. TRACEY: -- what's outside --

THE COURT: -- of what I'm talking about. What other parties put on a proof of claim is not probative of, frankly, anything because they will have done their own internal analysis or not of where they think recoveries are, they might have other collateral positions, there are a whole host of things that would come into that analysis, and it's -- and you'll forgive me, I sometimes can't remember

one set of Lehman claims from another vis-à-vis counterparties, but consistently, I have expressed my view that the filed amount of other claims, indeed the settled amount of other claims, is not probative as to where the appropriate level is to allow a particular claim. So, I'm glad you brought that up again, because I don’t believe that that's fair game. All right? So, we're not going to exclude a whole expert report on that, but when we get to it, I think that's -- is that Dr. O'Kane?

MS. DEL MEDICO: It is.

THE COURT: Yeah, okay.

MS. DEL MEDICO: And so, Your Honor, as a -- as a baseline for what's reasonable, your view is that that should not be used?

THE COURT: The filed amount of claims of other Lehman-facing counterparties is not relevant / admissible or probative of whether or not QVT's claim amounts are reasonable under the ISDA, okay?

MS. DEL MEDICO: Understood.

THE COURT: All right, so, that takes care of that one. So, Mr. Tracey, we go back to you for the -- QVT's post-filing valuations of the claim -- of the side pocket claims.

MR. TRACEY: Thank you, Your Honor. So, the issue here relates to, as I think Your Honor knows, the value --

the value --

THE COURT: Excuse me one minute.

(Judge confers off the record with Clerk)

THE COURT: We're just having a technical problem up here, so you're going to see a little activity, we're going to try to fix it, but we're not going to stop. All right? Go ahead.

MR. TRACEY: So, the issue is the relevance of the value on which QVT placed its post-filing claim against Lehman, and the -- as Your Honor knows from the briefs --

THE COURT: Right.

MR. TRACEY: -- at the time of the filing, and this is consistent with commercial practice, they moved the claimant to a separate side pocket, valued it at zero because they had no idea where things would be trading, and over the course of the next eight years, that number has changed. They look at what -- initially what claims -- allowed claims were -- what people in the market were buying allowed claims for, and considered that and put originally a 5 percent value on it. They later saw that allowed claims were trading at a higher level, so they put a higher level on it, and they ran all of that by PWC, their auditors, and the key inquiry, from an accounting standpoint, on what value you place on a claim, is what you think a third party in the market would likely pay you to buy that claim.

That's the level at which you have to carry it on your books.

THE COURT: But don't you have to -- understood. Don't you -- it -- doesn't it have two components? It has an estimate of the projected distributions, and also a risking of the likely notional amount.

MR. TRACEY: Correct.

THE COURT: Okay. So, to the extent that the valuation of the side pocket involved the latter as opposed to the former, why wouldn't that be fair game?

MR. TRACEY: The reason that wouldn't be fair game, Your Honor, is because it doesn't -- it doesn't bear on what the substance of the claim. It is an inquiry into what a third party in the market would come in and would say, here's what I think the likelihood is that you're going to win this claim and how much I think you're going to win.

THE COURT: So, let me ask another hypothetical question, and again, I'll reiterate that sometimes I'll give an extreme hypothetical to illustrate the point. So, suppose there was correspondence between and among the traders at QVT that said, now that we're past the claims process, we really have to get a better understanding of what our claim really is. Looks like we should have used numbers from September 16th instead of September 19th for the purposes of putting a nav on this for our investors, we

had better adjust it down, okay? So, wouldn't that be hypothetically probative of the good faith to show that you know, the process was flawed / not in good faith and therefore, that should be taken into account?

MR. TRACEY: Yeah, absolutely.

THE COURT: You can say, great, that didn't happen.

MR. TRACEY: Great, that didn't happen.

(LAUGHTER IN THE COURTROOM)

THE COURT: Understood. But so, how can I know -- I mean, to me, I'm 100 percent with you in the analysis of following where Lehman claims distributions would come in. 100 percent. But to the extent that there were adjustments made in their analysis of the notional amount of a claim as it impacts value, there's a possibility that that could reflect back on what was done in real time.

MR. TRACEY: So, I think -- I think we may have to address this --

THE COURT: Wait and see?

MR. TRACEY: Yeah, because --

THE COURT: I think so, too.

MR. TRACEY: -- because -- and if I could just --

THE COURT: Yeah.

MR. TRACEY: -- just distinguish two things. What Your Honor is talking about, and I fully agree, that if a

principal of QVT wrote an email -- I don't care if it's 20 years after they put in the claim, and said, we really don't believe in this, or we think we did it wrong, that's a relevant document. What I'm really talking about here, though, is a valuation that was placed on QVT's books based on what a third party would pay for a claim. So, assume that there's no, we think our claim is wrong, but what they do do is they say, okay, we've got a -- we have an unliquidated claim. We're not willing to guarantee any part of that claim to a buyer, it's going to be completely non-recourse --

THE COURT: Right.

MR. TRACEY: -- and we're clearly looking at years before we ever get this resolved, unless there's a settlement. Realistically, if there's a settlement, it's going to be way below what we're asking because nobody settles anything unless there's a huge discount, even if it's a perfectly good claim, and everybody knows that. So they say, okay, nobody's going to pay $265 million dollars for this claim, period.

THE COURT: Sure.

MR. TRACEY: And so they're going to say, the likelihood of $265 million is zero in a third party's mind. What would a third party say? Well, the third party might say $200 is a possibility but that's 50 percent. $150 is a

possibility, that's 40 percent, and that's how it's valued. That, Your Honor, I would submit, is completely irrelevant to this case.

THE COURT: Right, and I agree with that. I think -- and Lehman can speak for itself, but I think that the arc of what has been said about a lot of the aspects of this case is that the claim is inconsistent with QVT's internal discussions / analysis. So, to the extent that, I think they're saying, that QVT had a fiduciary or other responsibility to accurately report the position to its investors, they want the opportunity to look at that and say, you see, when it really counts, when they really had to put numbers on this, they took a different position.

MR. TRACEY: Well, but Your Honor, of course they did because it was all about what a third party would pay.

THE COURT: Sure. Right, so if -- but --

MR. TRACEY: So, who cares?

THE COURT: Right, so, I -- I don’t dispute that, but I think that this is also -- we're going to have to -- we're going to have to see.

MR. TRACEY: Right.

THE COURT: Because then now -- then they can explain, you know, huge inconsistency. And Lehman also highlighted in their brief, and I don't know what -- where they intend to go with it, but the economic stake of the

holders of the side pocket and how the percentage of the side pocket owned by principals has migrated over the years. And so, I don't know where they're going to go with that, but that was also, merited at least a footnote in their brief.

MR. TRACEY: It did. I have no idea why that's relevant. We can explain it, but again, and Your Honor's going to disagree with me on this because we have three weeks of trial, I don't think it's worth the time we're going to spend on it, but if you want to hear it, we'll -- we'll tell you all about it.

THE COURT: Okay. I won't comment anymore. We'll just see -- we'll see how it goes.

MR. TRACEY: Okay.

THE COURT: So, I mean, I think on this one, it's kind of a wait and see what they say, and that means that I reserve my right to kind of cut the testimony short if I think it's going into an area that I think is off limits.

MR. TRACEY: Sure.

THE COURT: All right?

MR. TRACEY: Thank you.

THE COURT: So, based on that, should I hear from you folks?

MS. DEL MEDICO: No, we'll wait --

THE COURT: Okay.

MS. DEL MEDICO: -- we'll wait and see --

THE COURT: Okay.

MS. DEL MEDICO: -- (indiscernible) Your Honor said.

THE COURT: All right, great. Okay, so, next is Lehman's. Okay.

MS. SAWYER: I think the first one is the privilege issue.

THE COURT: Right.

MS. SAWYER: The first privilege issue.

THE COURT: Right, so I got --

MS. SAWYER: Two privilege issues.

THE COURT: -- I got cases from both of you --

MS. SAWYER: Yes.

THE COURT: -- and I don't believe that what QVT has argued justifies a waiver of privilege. It's a timeline issue. There were a couple of statements that were quoted in your pre-trial brief at Page 55 that I just want to make sure I'm understanding, because you say that QVT asserts that it acted in good faith based upon consultation with external counsel, and I understood Mr. Tracey to be telling me that that's not the case, that it's not good faith based upon, which is not in quotes in the brief. There occurred consultation with external counsel, but that there's not a reliance on that. So, -- and Mr. Gold -- you also highlight

what Mr. Golden said. What Mr. Golden says on this issue is completely beside the point and is not -- I'm not going to take that as admissible. Similarly, Dr. Diplus testified that: "It shows that they're trying to do the right thing and that is the purpose of seeking legal advice." So, that's off the table as well.

So, I don't know that anything's left, other than the fact, as part of the timeline, that, during the couple of hours before the market quotation request went out, that they were, as a factual matter, talking to counsel, that fact will come in, but that's about it.

MS. SAWYER: I just want to point out a couple things that weren't pointed out in our brief --

THE COURT: Okay.

MS. SAWYER: -- because they came up in their brief. So, they have taken the position in QVT's brief that they said: "The Court will conclude at the end of the trial that there is not a whit of evidence of bad faith," and that's on Page 5 of their brief. That's exactly the type of statement that the Court -- the Courts in the cases that we provided to you, are concerned about, because there's no way for the Court, for you the Court, to evaluate that statement, "there's not a whit of evidence of bad faith," when we are precluded from hearing information about the advice that they received. And so, that's our concern --

THE COURT: But that gets back to what we talked about last time, which is that, therefore, everyone knows that in these situations, in some fashion, there's going to be consultation with counsel. So, where you are is that any time a party is -- any time good faith is at issue, the advice of counsel is in play and I just don’t think that that's correct.

MS. SAWYER: I would just also point out to the Court, and I heard you, but there are two interrogatory responses, contention and interrogatory responses --

THE COURT: Okay.

MS. SAWYER: -- which are inconsistent with the representations that have been made to the Court, which is also hard for us to square. So, one of the interrogatories, No. 19 is: "Is it your contention that you selected the day and time for referenced market makers to provide market quotations on the Lehman transactions in good faith? If so, state the basis for the contention." Answer: "QVT's selection of September 15th, 2008 is the early termination date in its request for market quotations as of 4:00 PM Eastern, was made in good faith, following consultation with external counsel, as to the form and content of the market quotation requests." So, when asked for the basis, that was QVT's response. Additionally, interrogatory No. 21 --

THE COURT: That's as to the selection of

September 15th as the early termination date, but you -- are you -- you haven't questioned the selection of September 15th. That's not really information that --

MS. SAWYER: The question -- the question that was posed --

THE COURT: -- go ahead.

MS. SAWYER: -- was whether QVT selected the day and time for the referenced market makers to provide market quotations on the Lehman transactions in good faith. So, it's specifically the good faith issue of the selection of date and time for the market --

THE COURT: Time for the MQ, okay.

MS. SAWYER: Right, and they say that they selected it on September 15th at 4:00 PM, according to their response, and they state the basis for that, the consultation with external counsel, as to the form and content of the market quotation responses.

Additionally, interrogatory No. 21: "Is it your contention that you acted reasonably and in good faith in your solicitation of the market quotations for the Lehman transactions? If so, state the basis for that contention and identify all documents and data supporting that." Response: "Yes. QVT acted reasonably in good faith, and based on the advice of experienced external counsel in its solicitation of market quotations for the Lehman

transactions." So, it's concerning to me that their representation --

THE COURT: Okay, so what's the -- so what's the effect of all that? So, the -- I agree with you that those are the -- if those are the positions, then that's -- that's different. But that's different from anything else that I've read, so --

MS. SAWYER: I mean, I think there's several arguments we've been making on this point, whether there's an implied waiver based upon the fact that good faith is an issue in the case, or whether there's an actual reliance upon their consultation with counsel in their defense. And so, those are kind of two distinct ways that QVT could have waived the privilege in this circumstance. I think that -- I mean, I think that the fact that good faith is an issue in the case, there is an implied waiver, but I understand the Court disagrees with that view. But I think that they also have expressly relied upon their consultations in counsel to demonstrate their good faith in this circumstance. And so, I mean, we're not trying --

THE COURT: Well, you have to -- you have to educate me on what's the effect of those interrogatory responses at this moment? What's the effect of it? Are those admissions? Is -- what -- what do I do with -- so it's a fact that those are the interrogatory responses.

What do I do with that?

MS. SAWYER: I mean, I think they could be moved into evidence as admissions against the party opponent, and I think that they could be presented to the Court in that way. They haven't yet, since we haven't commenced, and I think the person who verified those responses could be examined about those responses as well.

THE COURT: And that would lead to a waiver -- a subject matter waiver.

MS. SAWYER: I would believe it would, unless that -- I mean, that seems clear to me that that's where we would be at that point.

THE COURT: Okay.

MS. SAWYER: I also just want to note, for purposes -- I mean, I feel like this is like an 11th hour issue and you know, concerns about we're starting the trial today. We're actually in the trial today. I mean, we're not talking about a large volume of documents. We got a specific privilege log from QVT identifying 25 documents at issue that would need to be produced. Like, it's not like we're talking about something that would require days or delay or anything like that. I mean, it's a small subset of documents related to the market quotation issue that have been identified by QVT recently in response to our request for timestamps on the privilege log, and then it would be to

examine witnesses on the topic.

THE COURT: Okay, thank you.

MR. TRACEY: So, Your Honor, as I've said many times, we are not taking the position in this hearing --

THE COURT: But you did in those -- but you did in those documents.

MR. TRACEY: -- in the interrogatories we did, but until we put those into evidence --

THE COURT: But how -- but now -- now I feel that, then, that makes pre-trial a game of bait and switch because, to the extent that you answered those interrogatories that way, then Lehman would be entitled to inquire and develop that. So, now, I think what you're saying is, they don't really -- it doesn't really count until we, you know, put someone on the witness stand or we argue it here. So, I do have a little uneasiness about a feeling of bait and switch on that.

MR. TRACEY: Well, I -- it's certainly not intended as a bait and switch. I mean, we may have been over-inclusive in the answer just to be sure, but until it goes into evidence, there's no prejudice because we haven't asserted reliance on counsel as part of our -- as part of our claim.

THE COURT: So, I ask you the same question I ask Ms. Sawyer because it's beyond what I know. So, the effect

of an interrogatory answer is what?

MR. TRACEY: Well, it's a conten --

THE COURT: Once you start trial, so educate me.

MR. TRACEY: Right.

THE COURT: It's a contention interrogatory.

MR. TRACEY: Yeah, I'm free-wheeling a little bit here, so, just so you know.

THE COURT: You are too?

MR. TRACEY: Yes.

THE COURT: Okay.

MR. TRACEY: But --

THE COURT: This is where I call on the real Lehman Brothers.

(LAUGHTER IN THE COURTROOM)

MR. TRACEY: Maybe my team knows --

THE COURT: Do you have any?

MR. TRACEY: -- knows more than I do. I know. But, I think the way the Court would look at this is, unless a party relies on the advice of counsel as part of its evidence in a case, it hasn't been waived. So, they could say, tell me all the reasons that you think you acted --

THE COURT: But let's do it in order. You -- there was an interrogatory that was posed, and an answer was given. In sum and substance, the answer was, we relied on the advice of counsel in selecting the as of date and time

for the market quotation process. Now, Lehman says, aha, subject matter waiver, we get to get the documents, right? So, now, QVT is saying, you know what? Never mind.

MR. TRACEY: Right.

THE COURT: Right? Never mind.

MR. TRACEY: Right.

THE COURT: And so there's a credibili -- there's an issue because now there'll be a witness and the questioning will be, well, how'd you do this process? And they're going to make a statement that will be contrary either explicitly or impliedly, contrary to the interrogatory response that was previously given under oath or something equivalent to it. So, there's an issue.

MR. TRACEY: Well, the -- it's a tricky issue because --

THE COURT: It is.

MR. TRACEY: -- they did rely on counsel. I mean --

THE COURT: But you -- right.

MR. TRACEY: -- there's no doubt -- there's no doubt about that, right? That's -- there is -- that is the fact, okay? The question is, and that happens in every case.

THE COURT: That's right.

MR. TRACEY: The question is, are we going to

waive the privilege --

THE COURT: But you -- the interrogatory answer was, why did you rely -- what's the basis of your saying that you acted in good faith? And the interrogatory answer was, well, because part of it was, we got advice from counsel on the as of date and time for the market quotation process. So, look, here's the thing. We're never going to get through this if we spend the entire day on this issue. I would like to see the interrogatory -- those two interrogatories, I'd like you to look at them again. For the purposes of opening argument, you can just kind of bookmark this issue. You know, we're not going to re-argue it in the opening argument, and I'm going to have to think about it.

MR. TRACEY: Sure.

THE COURT: And I know it sounds a little bit like I make a decision and then I undermine myself, but I keep getting new -- I didn’t know about the interrogatory responses until this moment. So, why don’t you give those to me and I'll figure it out, all right?

MR. TRACEY: Okay.

THE COURT: All right?

MS. SAWYER: Thank you.

THE COURT: So, that was the -- the first of the issues. The second one was post hoc analysis and the back

testing.

MR. TAMBE: Yes. Good morning, Your Honor --

THE COURT: Good morning.

MR. TAMBE: Jay Tambe for the Debtors. So, there's a fair amount of discussion in QVT's pre-trial brief about analyses, circumstances, market conditions, during Lehman week. That was obviously the topic of a lot of discussion when we took that 30(b)6 depositions and went through all of the different valuation methodologies they used. And there was a series of questions that we asked about, what analysis did you do at the time, and we got whatever answers we did. But we also had a series of questions about what analysis have you done since submitting your statement of claim? And I want to play two clips to just tee up the issue because I think the testimony we got on these two points illustrates the issue we're dealing with, and what we want to try and manage as their fact witnesses take the stand. So, if you play Mr. Chu No. 1 if you have it.

(RECORDING: MR. CHU NO. 1 IS PLAYED)

MR. CHU: (ON RECORDING) Well, we looked the methodologies and (indiscernible) generally you know, discussions with counsel.

MAN 1: (ON RECORDING) Other than discussions with counsel, you haven't done (indiscernible) back testing

(indiscernible).

MR. CHU: (ON RECORDING) I'm not certain of the degree to which I talked about the -- whatever we did with the methodology because (indiscernible) discussions that were (indiscernible) discussions with counsel.

MAN 1: (indiscernible) expect you not to answer any (indiscernible) you had with counsel or (indiscernible) you had with counsel, yes.

(END OF RECORDING)

MR. TAMBE: And if we could play No. 5?

(RECORDING: MR. CHU No. 5 IS PLAYED)

MAN 1: So, Mr. Chu, if you could turn to Page 6 through 10 of the -- this document?

MR. CHU: (indiscernible)

MAN 1: (ON RECORDING) So, my question is, the analysis that's reflected in this document, related to market partners, the (indiscernible) analyses that (indiscernible) the form after it's (indiscernible) calculation statement to Lehman.

MAN 2: (ON RECORDING) I'm going to object and instruct the witness not to answer unless they're going to analysis that was done with the (indiscernible) and with the input of counsel specifically for the purpose of settlement negotiations. If you'd like to ask the witness what analysis he did of market (indiscernible) before September

28th, 2008, you can ask that.

MAN 3: (ON RECORDING) All right (indiscernible) witness (indiscernible) answer without dealing with the (indiscernible).

MAN 1: (ON RECORDING) Okay, I -- I'll ask that question with a reservation of rights.

(END OF RECORDING)

MR. TAMBE: So, that illustrates the issue we're dealing with in the --

THE COURT: Okay, but what you say, Mr. Tambe, in your brief is, having consistently precluded Lehman from inquiring about QVT's post hoc analyses and discussions, QVT should be precluded from arguing in the opening statements, et cetera, concerning those analyses. So, let's find out if that's a real live issue.

MR. TAMBE: I mean I can --

THE COURT: Yeah.

MR. TAMBE: -- tell you it's a real live issue by reading their brief.

THE COURT: Okay.

MR. TAMBE: In their brief, for example, if you look at Pages 36 to 37, there's unidentified back testing references with respect to PCDS in that section.

THE COURT: Where?

MR. TAMBE: So, it --

THE COURT: In the --

MR. TAMBE: So, in order to determine the price at which a hypothetical replacement dealer --

THE COURT: Right.

MR. TAMBE: -- blocks sale of $370 million, some 68 percent. I -- we have seen no evidence of any analytics like that done at the time. We are aware that they did analytics like that after the fact, but we weren't allowed to inquire into any post statement of calculation analyses they did. And now, we see in the brief, these discussions --

THE COURT: Let me look at it. (indiscernible) I was not under the impression that this was an argument of -- that QVT was arguing that, in order to come up with its PCDS valuation, that it did the block trade -- that it did this analysis. I was under the impression that that was what its experts were now saying. I did not read this as reflecting their argument that --

MR. TAMBE: So, that's part of the issue, right, is, it's in there and this is not the only example. There's other examples where there's numerical analyses offered in the brief, without citation as to whether the experts are going to talk about it or the fact witnesses. We certainly were precluded from asking the fact witnesses about post-calculation statement analyses they did, so they shouldn't

be allowed to venture into that area.

The experts have a similar problem, and I'll tell you why the experts have a similar problem. Take Professor (indiscernible) for example. He doesn't do any analysis. He does no numerical analysis. He effectively sprinkles holy water over what QVT did and said, this looks reasonable to me. Everything he knows about what QVT did, what they looked at, what analysis they may have done, is based on his conversations with Mr. Chu and others.

THE COURT: Sure.

MR. TAMBE: And so, again, he may well be relying on things, and we believe he was relying on analyses that were done after the fact because we know there were no analyses done before the fact. So, to the extent he's satisfied himself that there was some analytics behind what QVT did in making itself comfortable with this -- yes.

THE COURT: So, let me -- let me kind of -- I'm just trying to square what you're saying --

MR. TAMBE: Yes.

THE COURT: -- with what the objection is in the brief, because a lot of what the experts had to say was, we weren't there at the time, but, here's everything I know that leads me to believe that the numbers are or are not reasonable, right?

MR. TAMBE: Sure. So, that's a little different

but I don't have -- I wouldn't have --

THE COURT: Okay.

MR. TAMBE: -- a problem with that. I may have other problems with it.

THE COURT: Okay.

MR. TAMBE: The issue is when someone on their side opines that what QVT did was reasonable.

THE COURT: And you're saying that there's no -- that QVT has not identified anything that they did in the sense of they -- during -- that they tried to -- say for CARB, right, where they actually got pricing on the underlying ABS, right?

MR. TAMBE: Let's use that as an example. They didn’t do that.

THE COURT: Right, or with respect to PCDS, that they didn’t do an analysis, real time, of what it would cost to actually acquire a short position in the referenced securities.

MR. TAMBE: Right.

THE COURT: Is that what you're talking about?

MR. TAMBE: That's what I'm talking about. So, the analysis -- those are two examples. There's others that -- things they didn’t do at the time. You can have an expert come in after the fact and say, I spoke to QVT, they told me before they put in their claim, they didn’t do any

analysis. I've now gone into the market and looked at market data and here are my opinions. That's not what we're talking about. What we're talking about is an expert who comes in and says, I've spoken to QVT about what they did, and the reasonableness of what they did is supported by the following analyses. And now what they're talking about is things that were done after that point in time.

THE COURT: Okay. All right, so --

MR. TAMBE: So, both for the fact witnesses and for the expert witnesses, to the extent they're relying on analyses done by QVT after the fact --

THE COURT: Right, okay, I get it.

MR. TAMBE: -- that should be off limits. Yeah.

THE COURT: All right.

MR. TRACEY: I'm not sure we have any real disagreement here. To the extent that -- I mean, the critical issue, of course, as Your Honor knows is what QVT did before it filed the calculation statement --

THE COURT: So, again, let me do my advice of giving an extreme example, right? So, to the extent that they threw a dart, somebody threw a dart on a number and that's what they put on the valuation statement, right? And then after the fact, they said, let me see how good my dart-throwing skills were and they did analytics around CARB or PCDS or whatever it is and say, look, oh that works, right?

And then they don’t reveal what the analytics were, and an expert for QVT relies on that analytics, they ought to have had insight into that.

MR. TRACEY: I agree.

THE COURT: Okay, then what's the issue?

MR. TRACEY: So -- so I don't think there's an issue. So just because the --

THE COURT: Because there wasn’t that kind of post-calculation statement analytics or because there was and they know what it was?

MR. TRACEY: It's because, to the extent that QVT personnel went back and looked at their calculation in connection -- this was primarily in connection with counsel to deal with the mediation, we're not relying on any of that, and neither are the experts, and --

THE COURT: Okay.

MR. TRACEY: -- the experts are doing their own analysis and we're relying on that, and we're relying on what QVT did contemporaneously and there is lots of analysis around what they did, including, on that very issue of market impact, for selling a lot of preferred, Mr. Chu, when he did his initial calculation, looked at that issue, collected data on it, put it in the spreadsheet, and it's going to be open to everyone and we're going to be relying on it. that's -- so --

THE COURT: The way you describe it, it sounds like there's not an issue.

MR. TRACEY: I don't think there's an issue. But of course, if they think something comes up, they can scream, but I don't think there's an issue.

MR. TAMBE: The concern is the following: the concern is based on the statements we saw in the brief where you have statements made about analytics without a source as to whether that's coming from experts or fact witnesses. And we'll wait and see as it comes in, but the concern I have is, it may be too late once Mr. Chu and Mr. (indiscernible) takes the stand and starts talking about the analytics. This also provides the Court with some background as to what our concern is going to be if they start straying into areas where we were not permitted an opportunity to examine them.

THE COURT: Well, on this statement on Page 37 of QVT's brief, this is -- and this is about the PCDS, this is likely a conservative estimation of what it would have cost a replacement dealer to re-establish a short position with a guarantee borrow of $375 million of financial preferred stocks immediately after demise. So, what Mr. Tracey is saying, that in real time, Mr. Chu did an analysis.

MR. TAMBE: Well, that we can question -- that we can question Mr. Chu about on the stand.

THE COURT: Right, yeah.

MR. TAMBE: Sure.

THE COURT: Okay, and --

MR. TAMBE: But look at the very next sentence, Your Honor. That one about the percentages, follows right on that first statement. We know there was no such numerical analysis done at the time. And if there was, we've never been given any information about it.

THE COURT: Okay, well, I do -- I think we're going to have to revisit this when the testimony starts. All right, so, the final category is the overarching category of, in Lehman's view, the unsettling lack of documents that exist, and this is the first I've -- this is the first that I think I've heard of the timing of the litigation hold. I don't think I've heard about that before. I have -- I do recall from the discovery conferences that we had, that Lehman was concerned about the lack of documents that QVT produced, and QVT's position consistently has been, we're a small shop, it was a handful of people working in close proximity on the weekends, and we just didn’t generate a lot of documents.

So, I don't know at this point what I can do about this, other than to have the testimony come in. You're entitled to ask questions about everything that happened while they were doing their calculations. I suppose I can

make findings. I can -- of course I can make findings on credibility, and to the extent that Lehman believes that it's entitled to an inference in -- with respect to one or more points about the absence of documents, I'll hear you and we'll have to see. I'm not -- I don't exactly know what Lehman is asking for, frankly, on this.

MAN: As long as Your Honor is amenable to hearing arguments about adverse inferences and the like, at the appropriate time, that's -- we're fine with that.

MR. TRACEY: Obviously, the Court can consider any adverse inferences requested and honestly, dumbfounded that they're making this statement without any evidence that there's ever been a document destroyed. So, I just want to be on record very clearly with this.

THE COURT: I hear you --

MR. TRACEY: -- and sort of emotional.

(LAUGHTER IN THE COURTROOM)

THE COURT: That's fine. Again, I -- I was surprised when I saw this too, because there was -- the first I heard about this litigation hold, and it is a very -- it's a big deal to suggest that a party destroyed documents, so --

MR. TRACEY: Yes it is, Your Honor.

THE COURT: -- so, there's no evidence of that. I understand, you know, a litigator's reaction to, you know,

that you have an expectation of what documents should exist. I think QVT is entitled to explain it and I don't want it to be a Sword of Damocles hanging over anybody's head and I don’t believe we should spend a whole lot of time on it. I think we'll leave it at that.

MAN: Thank you, Your Honor.

MR. TRACEY: Thank you, Your Honor.

THE COURT: All right? Okay, did we finally decide how long you were going to take for opening arguments?

(LAUGHTER IN THE COURTROOM)

MR. TRACEY: I hope you're not going to take back your generous offer.

THE COURT: I'm not. I'm just trying to decide whether we should have a short break now for a couple of minutes and then how -- are you going to go three hours at a clip?

MR. TRACEY: We're probably -- we're going to try to keep it to two and a half hours --

THE COURT: Okay.

MR. TRACEY: -- and there are going to be three of us presenting --

THE COURT: Sure.

MR. TRACEY: -- and so, there'll be opportunity for --

THE COURT: For a break?

MR. TRACEY: -- breaks but this time might be a good time for a break, also.

THE COURT: Okay. So, let's just take -- let's take a short break. We'll try to come back at 5 minutes after 11:00 and then to -- just to be efficient, you want to call a lunch time now so that you could order your lunches to come in? Just so you know, I just want to put you on notice. So, I got a big new Chapter 11 filing this morning. So, I -- it looks like I have to have a first day hearing this afternoon, so we're going to have to deal with that, and then there's an assortment of other things, unfortunately, that I'm going to have to deal with. So, what it's going to look like is, I'm going to be doing something else every day, probably at 9:00, I'll have them cleared out by 10:00 and I'm going to be doing things at -- during your lunch hour. So, it's going to be important for me to be able to highly schedule everything. So, for today there's nothing at lunch hour. Okay, so what time do you want the lunch hour to be today?

MR. TRACEY: 1:00 to 2:00? Is that -- does that work?

THE COURT: Sure, 1:00 to 2:00 is great.

MR. TRACEY: Okay.

THE COURT: Okay. At the rate things are going,

we're probably not going to finish openings today, all right? I apologize. Can we do a 45-minute lunch?

MR. TRACEY: Sure, 1:00 to 1:45?

THE COURT: 1:00 to 1:45, yeah. Okay, all right, so we'll come back in about five minutes.

(Recess)

THE COURT: Okay. Do you have a dep for me?

MR. TRACEY: We do.

THE COURT: Okay.

MR. TRACEY: Your Honor, apologies. The rest of the copies are in the other room, so --

THE COURT: That's okay. We're good to go.

MR. TRACEY: We don’t even have one for Jones Day, so we'll just wait a few seconds, if that's okay.

THE COURT: Oh, okay.

MR. TRACEY: I didn’t realize I was going to be handing it up, so.

THE COURT: I'll tell you what. Why don’t you give this to Mr. Tambe or Ms. Sawyer --

MR. TRACEY: Okay.

THE COURT: -- and I'm going to look at my screen.

MR. TRACEY: Okay. They're (indiscernible).

THE COURT: All right? Every minute is going to be valued highly here, if that's not a pun.

(LAUGHTER IN THE COURTROOM)

THE COURT: Okay, go ahead.

MR. TRACEY: Thank you, Your Honor. And again, thank you for taking so much time for us.

THE COURT: Sure. Before you start, one second. As I was preparing over the last period of time, it became very clear to me how distinct -- there were distinct buckets of issues, which we've been talking about for a while, but it really crystalized with me as I've been preparing over the last couple of days. And so, as we're going through this, both -- I'm sure you'll do it in the opening and throughout the trial. It would be helpful just to help me continue to be able to bucket what we're talking about at a given time, and almost generate a score card, if you will, that includes which witnesses are speaking to which sets of issues. So, who was active on PCDS, who was active on CARB, and so that I can kind of schematically fill it out in my brain, you know, kind of like a memory palace --

MR. TRACEY: Yeah.

THE COURT: -- kind of a thing, if you know what that is, so --

MR. TRACEY: Sure.

THE COURT: -- so I'm sure that's what you're going to do, but I just wanted to underscore how important that is going to be to me as we do this exercise over the next, what looks like two months plus.

MR. TRACEY: Sure.

THE COURT: All right?

MR. TRACEY: Absolutely, we're -- we'll give you a road map and we'll hopefully follow it.

THE COURT: Great, okay, go ahead.

MR. TRACEY: Well, just to start, you know, I'm sure everyone thinks their cases are important, but this is truly an important case. There is a lot of money at stake and you know, QVT Fund and Quintessence Fund are investment funds that are overwhelmingly owned by outside investors and they are not here in this Courtroom, but they have entrusted their funds and their money to the managing partners of QVT and Quintessence to safe -- safekeeping, and this case is a very important part of the safekeeping of the funds for those investors. And, just to put it in perspective, how important it is, and I think Your Honor got this from the briefs, but 2008 was a tough year, and QVT in particular lost a billion dollars, it was about a $12 billion-dollar fund. It lost about a billion dollars before September 15th, lost another billion dollars in September and lost two more before the year was out.

And one of the hedges that they had against losses from a financial crisis of the kind were the protections that they had bought from Lehman. And as things turned out, they suffered the losses, but they do not have the benefit

to date of the hedges that they hoped would soften the blow. So, this case and its claim is very important to the investors. It's a small percentage of the overall portfolio, but it's an important -- it was an important cushion against that blow.

It's also, of course, important to QVT's management. QVT's management takes this very seriously. They have their own funds in these funds, and so it's important to them as well.

It's also important more broadly from a legal standpoint. I think there are some very significant principals at issue here under ISDA. This is going to be a very stark test of the ISDA principle that as long as the non-defaulting party acts reasonably and in good faith, they should not have to worry about being second-guessed by the defaulting party days later or years later.

In our view, that's what's happening here. Lehman hasn't called it that, but they've -- and they know that second-guessing doesn't work, so they've called it -- QVT's claim a grossly inflated claim, a market quotation process that was rigged, a loss calculation that was concocted, and ignored important factors. And they've refused to agree that any of QVT's expert witnesses have the expertise to testify. They've refused to agree to a single position that was properly valued.

They're going to present their own methodologies. And we're not saying that their alternative methodologies are all frivolous. It's in the nature of the valuation process that were going to be talking about for the next couple of weeks that there will be alternative reasonable rights and value of position. But we think Lehman's position here answers the wrong question.

The question they're answering is, is there a better way or a different way to value these positions. If that's what the question is, yes, there are. They think a lot of Lehman's are going to be unreasonable, but that'll -- we don't think you need to get to that. It's not the issue before the Court. It is whether QVT acted unreasonably or in bad faith. Again, unreasonably means no reasonable person would use the methods that QVT used. Or was QVT acting malevolently or intentionally in bad faith to inflate its claims?

I've said this before and I'm going to say it again. There will not be an iota of evidence of bad faith in this case. And with respect to reasonableness, we believe that the Court will conclude, and we hope you'll conclude, that they were eminently reasonable. And we will take you to that calculation. We will bring it to life as much as we can. We will put on the witness stand the people who did it from QVT.

Nothing -- no market quotation process and no loss calculation is going to be perfect. These were busy professionals working on weekends when they were trying to manage what was then a $9 billion portfolio in a very, very tough period. So, it's not going to be perfect. They made mistakes, but they're only mistakes. And I think the Court will see in the and that these are good people, they're honest people, and they really did their best under the circumstances to try to come up with the right answer here. And in doing that, I think you'll see their assumptions, their calculations, are all documented, and they'll based in the way they saw the market, based on their experiences, which we think is consistent with this.

So, I think the way to start -- oh, go ahead.

MAN: (indiscernible)

THE COURT: Thanks. Thank you.

MR. TRACEY: So, I'll start by just giving you sort of the map that we talked about. This is the way it's going to go. We'll start with the key background facts. We'll talk about the relationship between Lehman and Q. I'll give you a chronology of all the key facts going through the loss calc- -- first the market quotation, then the loss calculation.

Then we're going to frame it with the legal standards and Ms. Keller will address that issue. And then

we're going to go back to each category of valuation.

THE COURT: Great. Okay.

MR. TRACEY: And start with the PCDS, then the CARB, then the corporate and sovereign, which Mr. Regan will do. And then we're going to touch on Lehman's objections. So, that's the way it'll be organized.

THE COURT: Just as a minor housekeeping matter, to the extent that you can tell the reporters how to reflect CARB and PCD -- just, sooner rather than later --

MR. TRACEY: Sure.

THE COURT: -- let them know so that we can have as clean of transcripts as is possible. And on that point, talk about a detail. But in order to be able to accurately record Mark IT, you're going to have to call it Mark IT --

MR. TRACEY: Fair enough.

THE COURT: -- as opposed to Markit.

MR. TRACEY: Right.

THE COURT: All right.

MR. TRACEY: Fair enough. We will --

THE COURT: Sorry.

MR. TRACEY: We'll do that.

THE COURT: That'd be hard to do, but let's try to do that for the sake of the transcript. Okay?

MR. TRACEY: Sure.

THE COURT: Okay.

MR. TRACEY: I'm not sure I know how to do this, Your Honor.

THE COURT: Give it to a young person.

MR. TRACEY: Yeah. Ah, here we go. Okay, QVT. QVT Fund and Quintessence Funds are both funds that are managed by QVT Financial, which is the investment advisor. QVT Fund was originally a proprietary trading desk at Deutsche Bank. That's where the folks that you're going to see met each other and they started trading together at Deutsche Bank. They did very well. They spun off in 2003 and were asked by Deutsche Bank to continue to manage their money. And then they brought in additional investors over time.

Quintessence Fund was spun out of QVT in 2007 because one particular investor, a series of investors, wanted to have a separately managed fund. But the way it was done was just to take their portion of assets, move into a new fund, and all of the trading and all of the positions going forward were proportional. So, whenever a position was entered into, they would divide it up into two transactions, one for a QVT Fund and one for Quintessence. And it was about 9 to 1, so that's why in this case we have 836 individual positions, but only 400-some transactions.

I want to give the Court a sense of what the trading floor looks like and who the individuals are who the

Court is going to be seeing. The chart that's on the screen shows the entire trading floor. Each one of those rows is a double row of -- they're sort of like desks with monitors on them, and the white part is the little area where they can walk in.

It's not the palace, and as you can see, I've highlighted where the key individuals who were involved in this case sit. And so, they sit mainly in this central location between B and E. And so, the way it looks when you actually -- we'll show you a picture of it, but this is the way it looks. There are seats at each little desk and they sit with their backs to each other, but like very, very close.

So, these are the individuals that were involved and what we're going to talk about. Maybe I'll start with Dan Gold, since he's the CEO and Chief Investment Officer. But Dan was not really directly involved in most of what's relevant here. He had some involvement in the drafting of the market quotation solicitation, but was really not involved in it beyond that and was not really involved at all in the loss calculation.

Next to him is Arthur Chu. Arthur is a Managing Member of the firm and he is a portfolio manager. And it is Arthur who was principally responsible for both the PCDS and the CARB transactions. He was the one who entered into the

trades in the first place and he's the one who valued them as part of the loss calculation. And you'll obviously hear from Arthur.

Next to him is Joe Lowman. Joe was a partner, is no longer with QVT, but he will testify. He still has a consulting arrangement. Joe was also a portfolio manager. He focused a lot on EBS and was involved in the valuation of those positions. He also had a very important administrative role, both in market quotation and in the loss calculation. He was sort of the document person, so it was Joe who collected the positions to put into the market quotation solicitation and manage -- essentially manage the process. And he also was the person who created the original template for the loss calculation, which ultimately became the sort of base documentation for the loss calculation.

Tom Knotts is on the other side of Dan Gold. He was a portfolio manager. He is no longer with QVT. His specialty was emerging markets. He was in charge of the Argentina and Venezuela bonds and he valued those positions.

On the other side of the aisle, starting with Nick Brunn, Nick is a Managing Member of the firm and is also a trader. He was involved in the drafting of the market quotation with Mr. Gold, but didn't have a lot of direct involvement beyond that. And he also was involved in the

loss calculation, but he didn't have any positions that he personally valued.

Tracy Fu, another Managing Member, was not involved in the market quotation process at all. He was involved in valuing a couple of positions. The one that's at issue in the case is the interest rate swaps.

And then Lee Sen, also a portfolio manager, traded a wide variety of things, is no longer with QVT. He was not involved particularly in the market quotation process, but he was involved in the loss calculation, valuing his own positions.

MR. TRACEY: I wanted to give the Court a sense of what this really looks like. It's kind of messy, but that's where the Managing Members sit. And I've tried to label where they sit so you can get a sense of it.

THE COURT: It's labeled in the deck.

MR. TRACEY: Yeah.

THE COURT: In that hard copy. Yeah.

MR. TRACEY: (indiscernible)

THE COURT: Oh, you broke it entirely.

MR. TRACEY: (indiscernible) Let me just talk about the relationship between Lehman and QVT.

THE COURT: Mm hmm.

MR. TRACEY: This relationship goes back a long way. They started when they were at Deutsche Bank. The

primary salesperson when they were at Deutsche Bank was Michael Newman. He continued as their primary salesperson through the QVT period. Michael Newman had direct involvement in the sales process for PCDS and he will testify at the trial.

In addition to the trading relationship with LBSF, they had a number of other relationships, which will be relevant as we move forward. There is a prime broker relationship with LBIE and LBI, and also trading relationships with LBOTC and LBCS. And with respect to LBSF in particular, QVT, as the Court knows, entered into an ISDA agreement in 1992, formed with QVT in 2005 and with Quintessence in 2007. And both of those are guaranteed. Both of them are guaranteed by LDHI.

I just want to give an overview of the transactions that are at issue. I think it helps to, as we say, put them into buckets. There were four transactions in Auto CDS; that's CARB. There were 62 in PCDS. There were some -- almost 600 in corporate and sovereign, about 170 in mortgage, and two interest rate swaps. So, that's what we're going to be talking about.

Just a little basic background information on the claim. The ISDA was terminated on September 15th. The early termination date was that day. The calculation statement initially was submitted on October 15th, 2008,

before the collateral was used to offset the positions. And then on October 16th, 2008, a revised demand was sent after liquidating the collateral, which was about $117 million, with a net claim of $290 million. And then that claim was -- as a result of some -- noting some mathematical errors, some double counting, some foreign currency adjustment issues -- was reduced, actually back in 2010, to $265 million. But we never filed an amended proof of claim and Your Honor allowed us to do that in June of last year.

THE COURT: So, I must have misunderstood. I thought that when you described QVT and Quintessence that there were identical positions, but the numbers are not identical. So, why is that?

MR. TRACEY: Oh, why is there a difference --

THE COURT: Yeah. So, the number of transactions, except for the two -- or Quintessence has two fewer corporate insolvency CDS, but then on the calculation statement, the numbers are dramatically different as between QVT and Quintessence.

MR. TRACEY: Oh, I'm sorry. Because although they're proportional, for every dollar that is invested in a position by Quintessence, about $9.00 is --

THE COURT: So, different notional amounts?

MR. TRACEY: Correct.

THE COURT: Got it. Okay. Thank you.

MR. TRACEY: And then there's -- I wanted to give the Court an overview of the key valuation differences. As you can see in your book, the area --

THE COURT: Slide 12?

MR. TRACEY: Right.

THE COURT: Right.

MR. TRACEY: So, that's -- those are the valuation differences between the parties, based on QVT's claim and Lehman's expert valuations. Lehman's experts have a range, but we've -- just to be -- to simplify it, the percentages are based on the average. So, as you can see, and we've mentioned before, between PCDS and CARB, we're talking about 82 percent of the difference between the parties. And all of the remaining positions, the hundreds and hundreds of positions, is less than 18 percent.

And just taking those valuation differences, I just want to put it in perspective, in particular with regard to the margin. So, the total notional amount of the positions that QVT and Quintessence held with Lehman was about $2.5 billion. That was the amount of protection they had.

And so, this slide shows you the various valuations. And starting with the right, the margin amount that was posted against those positions as of September 11th, about, --

THE COURT: Mm hmm.

MR. TRACEY: -- that was the last margin mark. It was $117 million, or 5 percent of the total notional amount. Lehman's experts -- although Lehman has said that the margin is supposed to be the value, actually, they don't (indiscernible) saying that. The experts have acknowledged that the actual value is somewhere around double that level. So, the Lehman experts committed about $228.7 million, and that's 9 percent of the notional. And QVT's valuation -- this is including collateral -- is $382.3 million, about 15 percent of the total notional.

So, the key point that I want to make about this one is Lehman has taken the position that the collateral marks are some kind of a limit on what this value should be. That is just wrong, and it's wrong in so many ways because all you have to do is look at Lehman's own experts. And they don't believe that these positions should be valued at $117 million. They think it should be valued at twice that. QVT believes it's posted three times that. But whatever it is, it is not the margin marks. It's a different number. It's on a different basis.

We will go through in detail why the margin marks are not a fair representation of the value as of September 15th. It includes the fact that margin marks are at a midmarket. They don't include a bid offer spread, which is

part of the ISDA valuation process, because if the replacement value. Second, the margin marks were from September 11th. They did not include the catastrophic effects of Lehman going under. And there was a clear --

THE COURT: But on that point, Lehman makes an argument about the margin call that took place on September 15th into September 16th, and I think that the implication... Well, I'll let Lehman speak for itself. But I thought the implication of the argument was that there was a thought process around the level of margin at the time and that that shows that the much higher valuations that were later put on the positions should be discarded because, in fact, at the time they thought about it and this was a real valuation. I think that's kind of the argument.

MR. TRACEY: That's the argument. And that is factually wrong and theoretically wrong. So, from a factual standpoint, what that doesn't recognize is the fact that -- and there'll be lots of testimony on this -- QVT did not mark its books in full every day. It looked at it on a monthly basis. And secondly, most of those marks came from Lehman, the only dealer in these products. There was no other price in the market.

But most importantly with respect to that September 15th margin call, the facts, we believe, will show that from September 12th to September 15th, the mark on

these positions decreased by $5 million.

THE COURT: Right. Moved in Lehman's favor by $5 million.

MR. TRACEY: And moved in Lehman's favor. And --

THE COURT: But then they make the argument that then given that that's the case, then the additional margin call is a bad fact.

MR. TRACEY: But the --

THE COURT: Right. The additional --

MR. TRACEY: Just to be clear --

THE COURT: -- margin call was, they say, was just an attempt to get back original margins --

MR. TRACEY: Yes.

THE COURT: -- as opposed to --

MR. TRACEY: Exactly. That's exactly what it was. Because these positions clearly increased in value between September 11th and September 15th. These were protection on the most dangerous part of the financial economy that was going into the toilet. So, they clearly increased in value.

But what -- the reason that the marks went down between September 11th and September 15th is because the QVT system automatically marks things that are liquid, many of which did go down, but didn't touch any of the illiquid securities that went up dramatically in value. And so, the result is it's an incomplete mark, and so only the positions

that went down were remarked, and the ones that went up were not remarked. So, it's not going to be a valuable --

THE COURT: Financial --

MR. TRACEY: data point --

THE COURT: -- or --

MR. TRACEY: -- for anybody. So, that's a run through the basics. I think what we'd like to do now is present some of the legal issues as a framework --

THE COURT: Okay.

MR. TRACEY: -- before we go into the valuation (indiscernible).

THE COURT: Sure. Good morning.

MS. KELLER: Good morning. Robin Keller --

THE COURT: Yes.

MR. TRACEY: -- from Hogan Lovells, for QVT.

THE COURT: So, Ms. Keller, not to steal your thunder. If you'd like, you can walk me through all of the provisions that are in play here. I will tell you that I'm familiar with them. So, to the extent that you want to focus on, you know --

MS. KELLER: The case --

THE COURT: -- kind of the nitty-gritty of the issues, how they come into play here, that would be great.

MS. KELLER: Great.

THE COURT: If you want to go through, chapter and

verse, on all of the relevant instant provisions, I'll let you do that. But we might want to be more efficient.

MS. KELLER: I think we can definitely skip over those. There's no dispute there was a default and that QVT turned it into --

THE COURT: A non-defaulting party.

MS. KELLER: -- (indiscernible) 915 and it submitted calculation statements, as it was obligated to do. By the middle of October. The parties had collected second method and market quotation, and so QVT had to run a market quotation process, and only if that failed could they revert to loss --

THE COURT: Right.

MS. KELLER: -- on their positions. And that is what they did. They complied with the obligations of the market quotation process by soliciting the necessary -- or the list attaining quotes from the necessary reference market makers, appropriate reference market makers, and requesting those quotes as of the same date and time, as required in market quotation. And they have the discretion to determine the date and time, as long as they did so in good faith.

THE COURT: So, there is an issue, though, with respect to, I think, its 44 positions, as to which there was no market quotation process. And I think QVT has said that

-- and I don't know that there's a dispute on this, but QVT has said, honest mistake, they were just left out. Right?

MS. KELLER: That's exactly right, Your Honor. They had a large number of positions.

THE COURT: Sure.

MS. KELLER: It was a very frenzied --

THE COURT: Yes.

MS. KELLER: -- environment that day. They were trying to pull the data together. They thought they had sent market quotations out for every appropriate Lehman transaction. And years later, in the course of discovery, they were unable to locate evidence that those 44 positions had been put on a list.

THE COURT: So, your position, though, as a legal matter, is that that group accounts, if you will, for a failure of a market quotation process that would enable QVT to go to loss. That is a failure of the market quotation process that legally is no different from. We've sent out requests for bids; we don't get back the requisite number; that's a failure of market quotation; we go to loss.

MS. KELLER: Your Honor, this is one of the novel issues that Your Honor will be considering. The ISDA itself does not tell you what happens if somebody makes a mistake in taking a market quotation.

THE COURT: Right.

MS. KELLER: It doesn't say where you go then. There are some cases that have found, for whatever reason, a market quotation was inappropriate to use and for the most part, have reverted to loss.

There's also in the background the fact that market quotation itself says if market quotation fails or is not likely to give rise to a reasonable --

THE COURT: Okay.

MS. KELLER: -- response, you can revert to loss. QVT is not invoking that provision because they thought they had requested market quotations for everything. But included within the missed market quotations, there were a number of very illiquid positions, including the CARB, where they very likely would not have gotten market quotations back. They got very few market quotations back on a large portfolio that included more liquid positions.

And so, while we can't point to some language and say, yes, we get to revert to loss under these circumstances, we think, as a practical matter, that is the right way to go. And they did revert to loss because they thought they hadn't gotten quotations, and they did calculate loss, we argue, reasonably and in good faith on those missed positions.

THE COURT: Okay.

MS. KELLER: And loss, of course, is an amount

reasonably determines by the non-defaulting party in good faith to be its total losses and costs in connection with the total agreement -- sorry to repeat this, but it's important to our case -- including any loss of bargain, cost of funding, or loss or costs incurred as a result of terminating, liquidating, obtaining or reestablishing any hedge or related trading position.

One other section I'll just point out. I'm sure Your Honor is aware of it. Loss does not include a party's legal fees and out-of-pocket expenses, but Section 11 of the ISDA instant does provide for an indemnity by the defaulting party of the non-defaulting party for its legal fees and collection costs and expenses. And those have been very substantial, Your Honor, and QVT is seeking the recovery of those amounts.

Okay. Slide 25, Your Honor, a summary of legal issues, so a few fundamentals. This is a contract dispute under the close-out provisions of the 1992 ISDA Master Agreement. New York law applies. Lehman owes QVT damages for breach of contract, and only the amount is contested.

The Safe Harbor provisions of the Bankruptcy Code, specifically Section 560, apply, which permitted QVT to terminate or liquidate it swaps, seize collateral, and set off amounts under the ISDA agreements, following ISDA custom and practice.

Lehman objects to QVT's claims under a variety of misunderstandings of the facts and misinterpretation of the ISDA language, principles and applicable law. And the comments I make in the next few slides, Your Honor, are derived from the language of the ISDA agreements between the parties, case law cited in our brief, and anticipates the expert assistance that both Professor Jeffrey Golden, QVT's ISDA expert, and even Mr. Skylar Henderson, Lehman's ISDA expert, will provide to the Court regarding commercial custom and market practice relating to the interpretation of relevant provisions and the need for deference to the situation of the determining party, as this Court noted in the Intel case.

So, some of the issues are the scope of discretion for the non-defaulting party to determine its losses and costs from its side of the market, including bid offer spreads it would likely incur in replacing the swaps Lehman defaulted on. Another issue is whether innocent errors in the market quotation process should impact QVT's loss determinations. Another is whether QVT acted reasonably and in good faith in conducting its market quotation and loss determinations, including the use of proxy methodologies, where direct market quotations were unavailable.

Another issue is whether QVT could utilize market data from the days immediately following 9/15 to help it

determine its loss as of the early termination date. And lastly, as you've heard, whether QVT is bound by pre-default margin collateral marks, which were issued by Lehman in calculating its losses after Lehman defaulted.

THE COURT: Could you go back, Ms. Keller, to --

MS. KELLER: Mm hmm.

THE COURT: -- one of those.

MS. KELLER: Summary of legal issues?

THE COURT: Yeah. What's the answer to the fourth point? Your answer?

MS. KELLER: Whether QVT could utilize --

THE COURT: Yes.

MS. KELLER: -- market data? Well, both the definition of loss and 562 of the Bankruptcy Code talk about determinations being made on the early termination date, or as soon as reasonably practicable thereafter. And case law --

THE COURT: Well, this gets into this interesting issue of whether or not it's on, whether or not that language speaks to when you have to do the calculation, or as of when --

MS. KELLER: Right.

THE COURT: -- you have to do the calculation.

MS. KELLER: Your Honor, there's not an exact, crystal-clear answer to this question.

THE COURT: Mm hmm.

MS. KELLER: But there is guidance in case law and legislative history and custom and practice. And both the legislative history to 562 and commentary from derivatives experts indicate that there be times when it's just not going to be possible to get all the data you need to determine your loss, or a market quotation for that matter, on nearly termination date.

THE COURT: Right. So, I guess my question is, the -- September 15th was the early termination date. No doubt about that. To the extent that market quotations were solicited, they were solicited as of 4:00 p.m. on September 15th.

MS. KELLER: Correct.

THE COURT: We know that some of them came back, but the vast majority of them did not come back. So, then the QVT folks had to sit down and figure out where they got to revert to loss, and they did that. So, then the question becomes, under what circumstances can they base a loss calculation on where positions were trading on 9/16, 17, 18 or 19?

MS. KELLER: Right.

THE COURT: Right? And that gets into the question of as soon as reasonably practicable -- practical to the extent that there's market confusion or dysfunction

on the early termination date. So, I think that that's why I asked the question of you, what's the answer?

MS. KELLER: Well, what's so interesting about it is QVT did determine its loss as of the early termination date. But it looked at, as it was entitled to, what would be entailed in replacing the positions that Lehman had just defaulted on. And because some of those positions were so large in size for their applicable market, and so illiquid, they concluded that they could not do it on day one. And therefore, the only reasonable way to evaluate that replacement cost was to look at data over the next couple of days.

And Your Honor, there are cases that have allowed non-defaulting parties --

THE COURT: Sure.

MS. KELLER: -- to go eight, nine months down the road. You know, it depends --

THE COURT: But for a plain-vanilla one-off corporate CDS --

MS. KELLER: Sure, if --

THE COURT: -- that's a different thing, right?

MS. KELLER: Yeah. If they had, you know, where they sent out market quotations, for example, and people came back right away with responses, either, you know, that day or the next morning, I mean, that's data on the --

THE COURT: Right.

MS. KELLER: -- early termination --

THE COURT: But you don't get to wait and play the market.

MS. KELLER: Sure. That's correct. And that is not what QVT did.

THE COURT: I wasn't suggesting -- I mean, just in terms of ISDA, one of the purposes of the ISDA was to address the moral hazard issue and create a mechanism --

MS. KELLER: I want to --

THE COURT: -- where folks could avoid --

MS. KELLER: -- talk about that a little bit.

THE COURT: Okay. Go ahead.

MS. KELLER: And, you know, I think it's --

THE COURT: Let me not highjack your remarks.

MS. KELLER: -- a bit of a misnomer to talk about playing the market because, of course, you don't know if the markets going to go up or down on any given day. And, of course, in the wake of Lehman's filing, the markets were as unpredictable and volatile as they ever have been in our lifetimes.

And so, the reason QVT terminated on 9/15 was it wanted certainty of knowing where it stood. And the fact that it took a couple of days, or they looked at data from the succeeding few days to help them figure out when and how

and what it would've cost to replace, I think that is perfectly consistent with the idea that you do it on the early termination date or as soon as reasonably practicable thereafter. And you'll hear more from Lehman about how they cherry picked, you know, the best prices over the next couple of days. That is bogus, Your Honor. They did not do that.

THE COURT: Okay.

MS. KELLER: And you'll hear a lot more about that.

THE COURT: All right. Go ahead.

MS. KELLER: Okay. I don't need to tell Your Honor the 1992 ISDA Master Agreement is the industry standard in general use worldwide for formalizing derivatives trading arrangements. The closeout provisions are filled with contractual privileges for the non-defaulting party to make its own determinations regarding closeout and calculation of damages.

As Mr. Hendersen has said in his textbook, Henderson on Derivatives, you really do want to be the determining party, which QVT was. Closeout process is not intended to dictate uniform outcomes. As Your Honor noted in Intel, quoting Mr. Golden, Professor Golden, setting specific fixing times or prices was not the game. Neither was searching for the correct or perfect or even best

answers.

Great discussion is afforded to the non-defaulting party, as Professor Golden will explain. This was a deliberate trade-off between the regulators and the dealers in 1992 to soften the blow when second method was adopted, which requires a non-defaulting party to pay money to a defaulting party who is in the money. And that's not the way it was before 1992, and that was not terribly palatable to the dealers at the time. And part of the trade-off and inducement that ISDA gave them to agree to allow this methodology into the system was to give great discretion to the non-defaulting party throughout the closeout process.

Your Honor may hear a lot from Lehman about moral hazard around and end-user like QVT inflating its claim unreasonably, but that was not what ISDA's concern was. It was this issue of the unfairness of having to pay a defaulting party and how to mitigate that. Essentially, what was assumed in the '92 agreement was that except for really bad actors, who would act in bad faith and unreasonably, commercial practicalities, not to mention the requirements of the bankruptcy laws relating to submission of proofs of claim under oath, would enforce good behavior.

Loss is a general indemnity that's basic, Your Honor. Lehman attempts to read into the loss definition restrictions that are not there. Loss doesn't say that

proxy methodologies are not permitted, if adopted in good faith and reasonably determined. Loss doesn't say that pre-default calculations such as margin marks or valuations must be used or mid-market prices, or specific pricing from any source at any particular time of day.

The non-defaulting party is not obligated to derive a provably correct amount for its laws, or even to enter into actual replacement trades. Loss must be determined in good faith, no lying, no attempt to deceive, and determined reasonably, not arbitrarily, irrationally or perversely.

THE COURT: With respect to cost of replacement hedges, though, to the extent that a party determines not to replace a position, does it get to a sort of claim for what costs it would have incurred had it replaced?

MS. KELLER: That's correct, Your Honor. If it can replace, usually a party will try to replace. But if it can't or it doesn't want to, it doesn't have to.

THE COURT: But it gets to assert a claim for the costs it would have incurred --

MS. KELLER: Correct.

THE COURT: -- had it replaced it?

MS. KELLER: That's exactly what the loss definition says.

THE COURT: Where does it say that?

MS. KELLER: Sorry, Your Honor. I need to go back to Slide 23.

THE COURT: Mm hmm.

MS. KELLER: So, loss means the termination equivalent of an amount that party reasonably determines in good faith to be its total losses and costs in connection with this agreement, including any loss of bargain, cost of funding, or loss or cost incurred in terminating or replacing hedges. A party will determine if loss as of the (indiscernible) early termination date or at the earliest date thereafter as is reasonably practicable. A party may, but need not, determine its loss by reference to quotations of relevant rates or prices from one or more leading dealers in the markets.

So, nothing here says that a party has to incur an actual loss or actually replace its positions, or even look at relevant quotations of rates or prices in the market. You have a very, very broad discretion to determine the loss of your bargain, what you imagine, if you do so reasonably and in good faith, you would have obtained, had Lehman performed.

THE COURT: Okay.

MS. KELLER: Back to Slide 33, Your Honor. I just quickly want to touch on damages for loss under New York law. The law of New York is clear that once the fact of

damage has been established, the non-breaching party need only provide a stable foundation for a reasonable estimate of damages.

In the CDO case, it was noted that loss under ISDA includes loss of bargain and loss incurred in connection with the agreement. The contractually agreed upon definition does not require an evaluation of the non-defaulting party's actual loss or an evaluation of the success of any (indiscernible) hedge against actual loss. The absence of an actual loss on a reference obligation transaction, thus is not a barrier to (indiscernible) recovery of the expected benefit of its credit default swap transaction.

Likewise, in the Merrill Lynch case, the Court noted that the amount necessary to put the aggrieved party in as good a position as it would have been had the contract been fully performed is a basis for measuring damages. It must establish if suffered some loss, but need not prove the amount of the loss with certainty.

Your Honor, I should have mentioned that the ISDA is called a check the box form, which means that you can select New York law or English law under the same form. It was not intended that it would make a material difference which one you picked. That's not to say there aren't any differences between New York law and English law. But as a

general matter, there's actually more caselaw coming out of the English courts than there is in the U.S. courts, and there's a surprisingly little amount of case law in any jurisdiction, given the pervasiveness of use of the ISDA contracts.  So, occasionally, I'll refer to English law, not to tell you that it's binding on Your Honor, but simply to see what those courts have said about very similar contracts.

So, English courts have held determination of loss under the ISDA is a discretionary decision and courts should not substitute their own view for that of the determining party, but review only on a rationality basis and not interfere unless the decision maker has made a decision which no reasonable decision-maker would make.

Your Honor, I think we already talked about early termination and as soon as reasonably practicable thereafter.  I'll not on Slide 37 that Lehman has a very flawed view of how damages should be calculated and virtually no case law to support those views.  They repeatedly tried out the American Home Mortgage Holdings case, where a party determined a year after the fact a very large claim equal to the total amount of their (indiscernible), underlying (indiscernible) agreement and had collected cash flow on the underlying assets for a year. And the court said, well, there were reasonable determinants

of value that could have been made on the early termination date, and so that was not a good way to go. But that is inapposite as a legal precedent for this case.

In its prehearing memorandum, Lehman says QVT cannot satisfy its burden of proof, and they cite two cases for the proposition that when the court is presented with a range of reasonable valuations, it can look to the lowest reasonable valuation in the range. Those two cases, Your Honor, are inapplicable and the citation is inappropriate. Those are Bankruptcy Court cases out of the District of New Jersey and the District of Delaware. They do not relate to New York law. They do not relate to ISDA agreements. They do not relate to loss under and ISDA agreement. They are just simply inapposite.

Turning to Slide 39. You know, as we discussed, it's not crystal clear what happens if a market quotation process is breached or fails to Oak or the way it should. Lehman sites only to the High Risk Opportunities case. I'm sure Your Honor is familiar with that. Where High Risk proved that its adversary had improperly influenced the supposedly independent reference market makers through repeated efforts to cause them to lowball their quotations. This effort was concerted, ongoing and improper, and the court concluded that the parties must revert to loss.

Well, that's not our case, Your Honor. It was an

honest mistake. But that's precedent for saying that a court can look to loss if for some reason the market quotation fails. That was the position Lehman took in the Federal Home Loan Bank of Cincinnati, where they didn't like Cincinnati referring to pre-termination date marks. And they said loss should have been imposed when it favored them to do so.

I just want to point out another comment of Mr. Hendersen. In his derivatives treatise, he says, "Market quotation works best for liquid transactions, that is, plain-vanilla transactions. If a currency element, a longer-term, other indices or stranger structures are present, the quotations will bury enormously. Dealers may not wish to provide quotations where the terms of the terminated transaction are complex or contain unattractive structural elements. Commercial reality must be considered. If a reference market maker is contacted to give quotations of 15 off-market transactions, all with the same effective date, on the data quotation is requested, the trader may have some idea that the exercise is academic. One may query whether that trader will put in the same kind of effort as if it really expected the deals to be done."

THE COURT: So Lehman seizes on that, this subject area, and in its opening brief says, aha, it was QVT that wanted market quotations, and at the time QVT said, "We

continue to feel this is the proper method for valuing our positions. Most of our positions have a ready market with easily obtainable quotations."

MS. KELLER: In 2005 and 2007.

THE COURT: So in 2005, there was a ready market for PCDS?

MS. KELLER: No, no, no. They didn't have PCDS at that time.

THE COURT: Okay.

MS. KELLER: Okay? They were just starting --

THE COURT: Okay.

MS. KELLER: -- their relationship with Lehman.

THE COURT: Okay.

MS. KELLER: They were in the initial stages of building their --

THE COURT: Okay.

MS. KELLER: -- derivatives portfolio. And PCDS and CARB came --

THE COURT: Came after that.

MS. KELLER: -- after. 2007, 2008 was really the peak of those transactions.

THE COURT: Okay, thank you.

MS. KELLER: And QVT did seek market quotation. It thought obtaining market quotations was the best way to go. Lehman resisted it. They liked the flexibility

inherent in loss, which now they object to. And QVT intended to seek market quotation for all its positions, and would have been happy if it did. But it didn't.

Slide 40, quickly, Your Honor. What's good faith, what's reasonableness. The Good Hill Court said it's a duty of good faith, does not extend so far as to undermine a party's general right to act in its own interests in a way that may inci --

(Recess)

THE COURT: Please have a seat. Good to go? Sorry about that.

MS. KELLER: No problem, Your Honor. Just a quick matter of housekeeping?

THE COURT: Yes.

MS. KELLER: It appeared that some of the page numbers that I was referring were off from the deck.

THE COURT: That’s true. I was aware of that. No problem.

MS. KELLER: I apologize for that. The deck is right; I’m wrong.

THE COURT: I think all you did was say Page 37 when you were on Page 31. So, no big deal.

MS. KELLER: Okay. I was working on an earlier version. Just a few couple of last points, Your Honor. On what actually is Slide 37, just to make the point that the

burden of proven (indiscernible) bad faith should lie with Lehman. That’s the typical standard under New York law relating to the implied covenant of good faith. And obviously burden is not addressed in the ISDA or in the case law on that issue.

You know, just one other point on the introduction of the second method and the issues between the parties, it’s worth pointing out that another issue, not just having to pay the defaulting party its in-the-money amount, but the fact that the Debtor can collect interest from the non-defaulting party, but the non-defaulting party can’t collect interest from the Debtor. And that’s another significant unfairness that people were concerned about in giving discretion to the defaulting party.

Your Honor, my last few slides really are a run-through of a number of cases where Lehman estate representatives have gone into courts in the U.S. and the U.K. attacking discretionary determinations by non-defaulting parties, and they tend to get thrown out of court, Your Honor.

In the Anthracite case, a U.K. case, Lehman argued that the non-defaulting party produced a fictitious loss widely at variance with that party’s real gain. The Court disagreed, found the loss was reasonable, and that it is by no means axiomatic that in relation to derivatives,

one party's loss approximates to the other party's gain. That's the concept, I think, to keep in mind here. In the --

THE COURT: I'm familiar with Anthracite, and that was very unique facts because of the distressed position of the non-Lehman counterparty. So I don't know that that case really sheds much light on what we have. But I don't disagree with the general proposition.

MS. KELLER: Right. In the LBIE case against AG Financial Products in New York, the Court set out the standard for bad faith. Bad faith is implicated when a party exercises a contractual right malevolently for its own gain as part of a purposeful scheme to deprive plaintiffs of the benefits of the contract and engages in targeted malevolence in the guise of business dealings. Your Honor, there is no targeted malevolence.

THE COURT: I don't think that we're talking about targeted malevolence. You know, well...

MS. KELLER: Or anything rising close to that --

THE COURT: Well, it's not -- Mr. Tracey said at the top that the folks at QVT are good people. This is not -- this is a trial about a commercial dispute fundamentally.

MS. KELLER: Yes.

THE COURT: I mean, whether or not people are good people is not --

MS. KELLER: That's well-put, Your Honor.

THE COURT: -- is not before me. So...

MS. KELLER: Right. And the fact that they might want to maximize their recovery has been held by court after court to be an appropriate motivation as long as you don't lie, cheat, unfairly inflate, you act reasonably --

THE COURT: Well, I don't want to open a can of worms here. I don't know that I would use the words maximize recovery. They were -- they owed certain duties to their investors, they were trying to get it -- I think QVT's positions is it was a chaotic time; we were just trying to get it right.

MS. KELLER: Yeah

THE COURT: And even if at the end of this couple of months we're going to spend together I were to find against QVT in whole or in part, I don't think that what's before me is a finding that these were bad people. It may be... We're going to find out what happens. But I just don't want this to turn into a trial of people's character because I don't believe that that's at issue.

MS. KELLER: And, Your Honor, here not only did they try to do their best but they tried to be fair in what they were doing. You know, in the Michigan State case, Judge Peck found that Lehman was distorting and truncating the meaning of Section 560 in its very constricted reading

to prevent a counterparty from using market quotation rather than an alternative midmarket liquidation methodology that Lehman preferred, and noted the current litigation as an example of the delay, expense, and uncertainty that results when there's doubts surrounding the enforceability of contractual terms.

And, Your Honor, moving to the last slide -- last but not least, Your Honor's findings in Intel, where the Court read the definition of loss broadly, finding it does not mandate any particular calculation method as long as it was reasonable and in good faith. Lehman's view that a non-defaulting party having too much discretion to select a methodology is a recipe for wild uncertainty and unpredictability is misplaced hyperbole. I think we have a little bit of that here.

And noting, again, Professor Golden's comment that the drafters intended to build into the definition of loss a contractual privilege for the non-defaulting party to make its own determination. And we assume that the situations when a court would interfere with the exercise of that contractual discretion would be extremely limited. Thank you, Your Honor.

THE COURT: Thank you.

MS. KELLER: I'll turn the podium back to Mr. Tracey.

MR. TRACEY: Okay.

THE COURT: Okay.

MR. TRACEY: So, (indiscernible) and back to the facts, I'm going to take the Court through the default and the market quotation process first, and I'm going to take it pretty painstakingly because there is an issue about timing that I just want to go through. If the Court says move along, I will not be insulted. But I think it is important to talk about it.

So, just back to the days of the default, this is something you had to hear a lot about. It's nothing new but there will be a number of events that led up to this memorable day that are very important in this case and you'll hear them come up because they affected the markets. And some of them particularly affected the PCDS marketing and the card market. So, we're going to have to relive these times.

But the Bear Stearns issue occurred in March of 2008, and then in September, very importantly for this case, when Fannie Mae and Freddie Mac were put into conservatorship. And that was sort of a watershed time for a lot of things but it was definitely watershed for the preferred market.

Because what happened there -- you probably know all this but I'll just repeat it. The government came in

and they supported the debt. The debt was fine. It was trading at I don't know what -- close to 100 percent. And the equity and the preferred were wiped out -- essentially wiped out. And so it created a new potential normal for the difference between subordinated and senior debt and preferred. And that's what had had happened just a week before the Lehman bankruptcy.

Merrill Lynch was on the verge of bankruptcy, ultimately acquired by Bank of America, AIG was near collapse, and then on the early morning of the 15th, our clients woke up and had a big job to do. And so the first thing that they did after they determined to terminate was they engaged in a market quotation process. And I will take you through the chronology but just broad strokes.

You can see here that what they did was they wanted to make sure that they got the requests out to the market makers who were most likely to give responses. And so, since they had a wide variety of different kinds of products, they couldn't just send out a blast. Plus, that would make more work for them. So they divided it into three categories which they felt would match what the market makers were looking for.

The first one was CARB, which included PCDS, the second was ADS, and the third was emerging markets. And so they picked the market makers that they thought would be

most likely to respond. For corporate emerging markets they chose four. These are market makers they dealt with on a regular basis, had a good relationship with. And on ADS they actually chose, I think, seven, because they wanted to make sure that they got responses.

So, this is a summary of what happened. As the Court knows, there were three or more only on 12 positions. There were one or two market quotations received on 173 positions; and for the other 545 there were no market quotation responses. Excuse me.

I've touched on this before but I wanted to show you which positions were missed as a result of the way they collated the information, and Joe Loman will explain this to you when he testifies. They left out these 44 positions. They are virtually all mortgage-related positions. And there were, as you can see--it includes the CARB as well as small amounts of other positions.

I wanted to spend some time talking about the 4 p.m. deadline issue that's been raised by Lehman. So, just to go back to the ISDA for one moment because it's important. What the ISDA provides is that the market quotations are to be obtained as of the same day and time without regard to time zones, and that day and time is to be determined by the non-defaulting party in good faith. It doesn't talk about when the responses are to be received; it

talks about as of time.

So, this was the -- and we'll provide this whole thing to you -- but this was the market quotation solicitation that they ultimately sent out. And what that said -- it tracked the ISDA exactly. It said, "Please provide market quotations as of 4 p.m."

THE COURT: So, is this true -- you say the 4 p.m. deadline. So I believe that I've been told -- I don't know if it's in the papers or not -- that some of the quotes did say that -- and I don't know if it's instead of this language or as a cover to --

MR. TRACEY: It was as a cover.

THE COURT: As a cover, said, please supply your responses by.

MR. TRACEY: Correct. That was Tom Knox, the emerging markets ones. And he did put a cover note on saying, "Please provide your responses by 4 p.m." That was a small minority of positions. Most of them went out only with this language. And his actually had this language, too.

THE COURT: So, the question that I have is -- my recollection from what we've talked about in pretrial was that these went out at 2:50-something?

MR. TRACEY: Between a little before 3 and about 3:20, except for one that went out at 3:44. And I'm going

to go through the chronology with you.

THE COURT: Sure. But at what point -- they wouldn't have been sent out at 3:55, right?

MR. TRACEY: Right.

THE COURT: And then you get into the question of when you're soliciting market quotations, what are you asking for? You're asking for actionable quotes, you're asking for live quotes, you're asking for are historical quotes okay? All of that -- you know, all of those issues. But the relatively narrow window of time that would be included here, it raises all those questions. Because at a certain point I don't think you -- they wouldn't have sent out these market quotations at that point. And then I think under the interpretation of the ISDA that you would argue that one might take the position that it wasn't reasonably practical to get it done on the day of September 15th, because of widespread chaos, etc., etc., and that if you had sent it out first thing on Tuesday morning, that would've been perfectly okay. The markets would've settled, inter-dealer stuff would've tamped down a little bit, etc.

So, I'm just anticipating that that's some of the things that they might say. But just focusing on the narrow timeframe, what's the argument?

MR. TRACEY: So, the answer, Your Honor, is that if we had to deal with a situation where we sent out a

market quotation and said you have to get it back by four, and then we didn't consider responses after four, that would be one thing. We don't have to consider that. What we have here is a request for an as-of quote.

Now, can you do an as-of quote as of 4 o'clock and send it in at 5? A lot of people did.

THE COURT: By send it in, you mean go out to the market with that request? So, at 5 o'clock -- no?

MR. TRACEY: I'm sorry, I was not clear. The request to everybody said give us your quotes as of 4 p.m.

THE COURT: Right.

MR. TRACEY: A few people got responses back in the 4 p.m. period; most of them, as you'll see, came in 5, 6, 7, 8 o'clock, and the next day. So, the communication to the market makers told the market makers that it was fine to respond after 4 o'clock. Whatever they were seeing in our solicitation, which you'll read, whatever was going on in the market, whatever they interpreted a market quotation process to be, they felt comfortable responding over -- mostly over a 4-1/2 hour period after 4 o'clock, giving quotes as of 4 o'clock.

So, maybe Lehman will say, "How can you give a quote as of 4 o'clock when it's later?" But that's what everybody did. And this market quotation process, there's no playback for it, right? There's a playbook for auctions.

They're used to that. But this doesn't happen every day. And so when a market maker got this language, they knew what was going on. They knew this was a market quotation process. That's what it says.

And so they felt comfortable giving prices as of 4 p.m. for the following four hours. That is a valid market quotation process. That's what this requires. It says as-of. It does not say if a market quotation comes in an hour later, you should deem it to be non-actionable or you should deem it to be not a valid market quotation as of 4 o'clock. It doesn't say anything like that. And that's not the way the market interpreted it.

So, I believe the answer is that this was consistent with a view that the market makers believed they could come in after 4 o'clock and give 4 o'clock prices. And I don't think there's going to be anything inconsistent with that.

So maybe we should go through the timeline of the day?

THE COURT: Sure.

MR. TRACEY: Because that'll give you a sense of actually what happened. So, the market quotation process lasted across two days. I'll take you first through September 15th. And it started in the morning, deciding to terminate between 7 and 9 a.m. After that, between 9 and 11

o’clock, QVT was preparing an initial draft of the market quotation and began to compile its positions with Lehman.

Between 11 and 1:40 was the bulk of the drafting process. It went through a number of drafts with comments coming back from various people. And I’ll take you through minute by minute. 11:02, Joe Lowman prepared a list of positions that were in his ABS area, which he was most familiar with in a market quotation format that he would later propose to others.

At 11:11, he sends an email to Dan Gold and says, “Have you finalized the format for the CDS bid offer requests?” He said he was thinking of conducting a 1 p.m. auction. And there are a number of these going on in the market. He gets a response four minutes later: “Not yet; stand by” from Mr. Gold.

At 11:17, he circulates another example of a market quotation process that’s in the market to the other partners involved in this. At 11:28, he circulates his own market quotation list, the one I showed you earlier, to Mr. Brunn, Mr. Gold, and Mr. Chu, and said, “Here’s what I was thinking of doing. It’s primarily an ABS-type request but you could adopt it to corporate.”

At 12:30, Nick Brunn sends an email to the others saying, “Attaching proposed language,” which is somewhat different from Mr. Lowman. At 12:34, Joe Lowman responds

and he says, “The first paragraph looks good; the second paragraph doesn’t seem to apply to ABS, my area.”

At 1:06, Joe Lowman proposes some, what he calls minor changes to the language. And then at 1:41, Nick Brunn circulates language called revised language, and this is essentially the final language. There are some small differences but that’s essentially the final language. So they got it done by 1:41.

At 2:06, Joe Lowman with that final language circulates an email saying, “Here’s where you can find all the positions.” He had put files on a server with these three separate lists of positions and he’s saying at 2:06, here’s where you can find the positions to attach to this language. And so then the first one went out at 2:57. So, Joe sent his out within a minute of each other for the corporate. The ABS ones went out about 10 minutes later at 3:08, and the emerging markets ones went out about 12 minutes after that. For some reason, Barclays didn’t get theirs or it wasn’t sent, so that was the last one that was sent out at 3:44.

And then what’s most important is to see what happened after that. Beginning at 4:05... I’m sorry, beginning at 4:05, you’ve got responses. I guess you have a couple of responses before that from UBS, which are in green down at the bottom, but mainly the responses start coming in

at about 4:05. And as you can see, they come in throughout the evening. Everybody worked late that night. They were all working on these things, and they were coming in throughout the evening until 8:20. And then including the following day when some additional ones came in early in the morning and then midday.

So that's the chronology, and that's why I say that this was a market quotation process that worked. Because those market makers responded and they responded at the time they thought that it was appropriate with quotes that were as of 4 p.m.

So, they got the number of market quotations they got and the next thing they had to do was address the loss calculation. And that was done -- the five people who were most involved in this were, as you know, the five main traders for the entire portfolio, and this was an incredibly stressful, difficult time, so they decided to do this on two weekends during September. And they met in the trading area that we described and performed their calculations.

You know, it's -- I think we touched on this earlier but on the issue of why they weren't emailing each other, you can see how close they're sitting to each other, and while they -- you can imagine somebody emailing their partners even though they're sitting nearby, if it's during a trading day and people are busy and somebody's walking

away. But this was on weekends. There's nobody else around, there's nothing going on, nobody's getting up to look at the market. And so they're working together orally to get this done.

How did they go about the loss calculation? There were certain priorities. Obviously, if there was a market quotation that succeeded, that was the first priority. If it didn't, there were certain positions that were replaced. So, the calculation was essentially just to adopt the replacement price.

And this is an important point that I just want to pause on for a second, because I can't remember exactly how many positions were replaced but not an insubstantial number. A small part of the portfolio -- about 80 or 90. I can't remember the number but I'll get it for you. Those were done -- some were done on September 15th, some were done on September 16th because you couldn't get them all replaced, the ones you wanted to, and maybe a few on September 17th.

Our loss calculation says, okay, what did we lose as a result of the loss of that position? What was our loss? Our loss was how much did it cost to replace it? And if that replacement took place on September 15th, that was the number.

If we were -- if it reasonably took us until

September 16th to replace the position, that's the number that was used because that's our loss. We lost a position, we had to go out and get it, we replaced it the following day, so it was whatever price we paid on September 16th.

So, right there you're done with the argument that you can't consider the next day. You're done. When you replace a trade on September...

Now, if we had sat around not replacing things, thinking that you could inflate your claim somehow by waiting on the replacement, of course that would be wrong.

THE COURT: That would be wrong. Right.

MR. TRACEY: Right. But --

THE COURT: And if you were able to do that because you have a cushion of margin or because you're willing to take a shot, that would be wrong.

MR. TRACEY: That would be wrong. But assuming that that didn't take place, assuming that they were being reasonable in their replacement process, and assuming that it reasonably took them until September 16th to replace it because September 15th was so busy, there weren't available bids, whatever -- nobody's going to say you can't use that September 16th price even though it's not September 15th; it's September 16th. That's fine as a replacement price.

And so when we get to the valuation of the positions that are not actual replacements, it's basically

the same story. If -- what we lost was what it would've cost to replace the positions. So if we couldn't have replaced the positions until September 16th, that's the number that was used. If because of liquidity or whatever reason it's likely that that would've been replaced on September 16th, that's the loss number. It's a rational approach to how you come up with a price. So, I just wanted to go through that because it's important.

THE COURT: But that doesn't necessarily speak to using price data later in the week, right?

MR. TRACEY: Well, if you think it would've... Most of the -- other than PCDS, the vast majority of dates that were used were September 16th because the theory was we just did a market quotation process, we couldn't get rid of it, so of course we would've replaced it on September 16th. There are some positions where they looked at it and said, there are no buyers out there. We're going to have to work this. It's going to take them until the 17th.

So you'll see which positions they did that for and they will explain why they did it, and if you accept that they were applying a reasonable approach to that, there's nothing wrong with it. Just because it's not September 15th. But, of course, you have to be satisfied it was reasonable.

Okay. So, calculation of loss. First is

replacement trades, second is the traders were basically given the discretion because they knew their positions to consider a variety of different inputs. And these are the three primary ones. First is market quotations where fewer than three were received. In most cases, if they received one or two, they used the one or two market quotations they received. There was one trader who didn't do that but most people did that. And so the market quotations, the 173 that you saw on that prior slide that came in where there were not three market quotations, most of those were used as the loss number. So they weren't running away from the market quotations; they were using them. They just didn't have that many.

The second one is the use of a pricing service, and the one that was used primarily was Markit, Markit Partners, and that price was a mid-price and so they needed to add a mid-bid spread to that, and we'll show you how that was done. And the third approach was using broker quotes. Those are the rungs that come out on a daily or even more than a daily basis from brokers offering to buy and sell things. And so in some cases they felt that those were fair representations of what the price should be.

I'm about to go into the valuation of PCDS. Should we look forward to that for lunch?

THE COURT: It sounds like a fine place to stop.

Nothing gets your appetite up than PCDS valuation or CARB, but that’s another bad joke.

MR. TRACEY: Hopefully, I won’t ruin your dinner.

MAN 1: That’s up to me.

THE COURT: Don’t even go there. All right, so what time did we say we’re coming back?

MR. TRACEY: 1:45.

THE COURT: All right, so here’s the thing. At 4:30 I have to do a first day hearing because apparently ships are about to be arrested in various places in the world. So, I have no idea how long it’s going to take. It might only take until 5 o’clock, in which case I would love you to not have left so we can continue. So, I’m sorry.

MR. TRACEY: No problem.

THE COURT: It is what it is. So, once we approach that point, I won’t ask you to decamp but just to kind of tidy a little bit so that the shipping folks can get in here. But I would like to continue as long as we can because it doesn’t look like it’s going to get done with closing markets -- with opening markets.

MR. TRACEY: Right.

THE COURT: All right? So, what time? We’ll come back at 1:45?

MR. TRACEY: Yes.

THE COURT: Okay, great.

MR. TRACEY: Thank you, Your Honor.

THE COURT: Thank you.

[BREAK]

THE COURT: All right, ready when you are, Mr. Tracey.

MR. TRACEY: So, just to take us back, we're on the --

THE COURT: PCDS.

MR. TRACEY: PCDS, the lost calculation for PCDS. And I will start with a big overview of what the PCDS were. There were 19 entities that were underlying reference entities. The total notional amount was $371 million of protection on these banks. And ultimately QVT's valuation, which I'll take you through, was $134 million, 36 percent of the notional.

THE COURT: And what was Lehman's valuation?

MR. TRACEY: About 22.5.

THE COURT: 22.5?

MR. TRACEY: Their experts were between 20 and 40. Bear with me just a few minutes. I know the Court is familiar with CDSes, but maybe before addressing PCSes I can just take the Court through the basic mechanics. It works like any other CDS in some respects, and there are some differences that I'll come to.

But QVT is a protection buyer. It's, as the Court

knows, essentially like insurance. QVT wants protection on the potential decrease in value of preferred securities and financial institutions. It goes to Lehman, which is willing to be a protection seller, and in this example, it’s Wells Fargo preferred stock, $10 million notional. And Lehman agrees to provide protection on that amount.

Lehman charges -- there are a few ways to skew conventions for pricing and I want to take you through those.

THE COURT: Sure.

MR. TRACEY: This convention is using a running spread which is essentially an annual premium based on the percentage of the notional amount. So, in this case, the annual premium was 150 basis points. That’s 1-1/2 percent of the notional of $10 million. So QVT in this case would -- if it were a five-year protection contract, AVT would pay $150,000 per year for five years.

Lehman would agree in return to provide protection. And that is paying QVT the $10 million -- if there were a credit event, and we’ll come back to that is -- paying QVT $10 million in return for returning the preferred stock or the value of that, depending on how the contract worked. And so the cost of this would be $750,000 over five years.

This is the alternative convention that I wanted

to go through. If a CDS contract becomes expensive, if the underlying reference obligation is distressed, the convention was that the parties would not use just an annual premium for the cost; they would insist on an upfront payment and would deduct that from the total payments.

So, in this case let's say that Wells Fargo had become more distressed, still $10 million of notional amount, but the cost that Lehman wants to charge for the five-year contract is $3 million, let's say. Instead of charging whatever that is, 600 basis points, what they do is they just have a running spread of 150 basis points, which is the standard, and they charge QVT upfront the number of, quote, "points" from points that would be needed to make that $150,000 a year cost work over the course of five years.

THE COURT: Is this the same thing as pay as you go?

MR. TRACEY: No, this is not pay as you go.

THE COURT: No. Okay.

MR. TRACEY: We'll come to this. This is a situation where there's a single credit event and either they pay the entire five-year contract and it's done or there's a credit event in the middle and the full payment is made.

THE COURT: I'm not following this one. So, tell

me again.

MR. TRACEY: Sure.

THE COURT: So, this is 150 -- the first one was the protection buyer pays $150,000 a year.

MR. TRACEY: Right.

THE COURT: In the second one --

MR. TRACEY: In the second one the total cost of the contract is $3 million Lehman thinks. So over five years that's $600,000 a year. But they don't like to do it that way. So what Lehman would do is they would charge 22.5 upfront points. 22.5 points is 22.5 percent of the notional. So, in this case, that would be $2,250,000. On the day of the contract inception QVT pays Lehman $2,250,000 plus they pay $150,000 a year.

THE COURT: Got it. Okay.

MR. TRACEY: That doesn't come up in the context of QVT's purchases because they were purchased before it was heavily discussed like this. But this convention will come up when we get to September 15th.

So, how are PCDS different from CDS? There are a couple of differences. Obviously, one is that instead of debt, the reference obligation is preferred stock. The second is that there's an additional trigger beyond the triggers that normal CDS have. It would include bankruptcy, restructuring, the traditional credit events. But it also

included deferral, which is an important concept here.

And what that is is that -- as Your Honor knows, preferred stock have a coupon but it’s not a legal obligation to pay. And so in the event that an institution wants to conserve capital, becomes distressed, it can defer or cancel its payments on its preferred stock -- something that would happen as you get more distressed.

They don’t default on anything; they just defer. They say, we’re not going to pay at least this coupon. One coupon deferred and that’s a credit event under PCDS. And the protection seller has to pay the $10 million less the then current price of the preferred stock. So, it can be powerful protection.

The third differences, the recovery may be different and it depends on the circumstances of the default. If it’s a full default, the recovery on a preferred stock is likely to be lower than the recovery on debt because it’s lower in the capital structure. If it’s a deferral situation, it’s not --

THE COURT: It’s not clear.

MR. TRACEY: It’s not clear.

THE COURT: Right. In other words, in a deferral situation, it’s not immediately clear that the equity -- that the preferred position has become worthless?

MR. TRACEY: Exactly. So, recovery might be

higher. But the protection seller is still required to pay the par amount and takes that full risk, and gets back the preferred at probably a higher level.

So, the last and important difference is there was no liquid market for PCDS. Unlike CDS, which can trade all the time, PCDS was invented by Lehman, they tried to make it work with other dealers; it didn't work. They had the trademark on it. It was their product. It was a proprietary product in which for most of this period they were the only dealer making a market.

So, just focusing on September 15th, which is the key moment, if you look back and you said, okay, those 19 obligations -- when was the last trade? In most of them it was July of 2007.

THE COURT: You mean the last trade on PCDS?

MR. TRACEY: On PCS in those referenced entities.

THE COURT: Okay.

MR. TRACEY: In some of them there were trades in July of 2008 but I think -- and there may have been one unwind between July of 2008 and September. But there just weren't any trades to look at.

THE COURT: So, because of that lack of trades then, what QVT did -- this is a question -- is they said, all right, so we have to figure out what it would have -- what it would have cost to obtain a short position? They

synthetically -- kind of reverse-synthetically --

MR. TRACEY: Exactly.

THE COURT: -- figured out what a short position would've looked like and what it would've cost.

MR. TRACEY: Exactly.

THE COURT: So then my next question is what's the significance of looking -- so, when last seen, markets closed to the extent that markets close, these markets close maybe -- ish -- at, say, close of business on Friday, the 12th, right? And then we go into pre-Lehman weekend, etc. So, am I looking at -- are you going to tell me that I'm going to look -- I shouldn't look at market movement between the end of the day on the 12th and when the positions were valued, taking into account what happened on the 15th?

To say it a different way is -- so these underlying securities, distress was already going on in a big way among financial institutions, and I think that you highlighted in your papers like, these were the eye of the storm, right?

So, am I supposed to be looking at the decline in the prices of the underlying securities that occurred between the 12th and the 15th?

MR. TRACEY: So, it could be interesting to look at the decline in the value of preferred securities, because obviously the PCDS which referenced them are going to be

somewhat related to that. However, that is not an available valuation methodology for QVT on September 15th, and I will tell you why. There's two reasons.

The first is you don't have a price for PCDS on September 12th.

THE COURT: Right. I'm not talking about PCDS.

MR. TRACEY: Oh. Okay.

THE COURT: I'm talking about, to the extent that the methodology that QVT is now saying should be used because there were no bid and ask on PCDS, they're looking at what it would've cost to short the actual stocks. Right? So, therefore, are you looking at the stock price -- the decline of the individual financial institution securities?

MR. TRACEY: That's exactly what we're looking at. But the way they develop the prices, they said, okay, what would a dealer on September 15th charge us for protection? What upfront points -- we're in a distress situation here -- what upfront points would a dealer charge us?

THE COURT: Right. But the way they come up with that is what would it have cost us to go out and acquire a short position in the actual underlying securities as a proxy for the protection?

MR. TRACEY: Exactly. And so what their analysis was is that the dealer, a dealer that would sell them protection would have to go out into the market and short

the stock --

THE COURT: Right.

MR. TRACEY: -- and would receive in return for shorting the stock some amount of money.

THE COURT: That's right. Okay.

MR. TRACEY: Say it was trading at 60 percent; they're going to get $6 million from that. What that dealer, according to QVT, would charge QVT for that protection would be 40 percent of the notional.

THE COURT: Okay. I mean, that's what my understanding was of what your analysis is. Okay.

MR. TRACEY: Right. Exactly. So the lower the preferred prices on September 15th or whatever price was used, the more the premium would cost to QVT --

THE COURT: Yeah.

MR. TRACEY: -- and the more valuable it is; and the higher the preferred stock is, the lower the premium, the lower the value of the PCS is.

THE COURT: That's what you say.

MR. TRACEY: That's exactly -- yeah. That's what I say.

THE COURT: Okay. No, I just want to clarify. When I say okay, it doesn't mean I'm agreeing with you; it means I hear you.

MR. TRACEY: Yes. No, no, right. Okay. And

maybe I can take you through what hedging is all about because that's the foundation of the valuation methodology. So, here where QVT is buying protection from Lehman, Lehman has this potential $10 million or almost $10 million contingent liability hanging over its head.

So what does Lehman do? Lehman goes out and buys protection from another party. AIG in this case was a common counterparty to Lehman, selling Lehman protection, and Lehman then sold the protection to QVT. And AIG was selling a lot of protection in the good old days but they ran out of interest in that, as did everybody in the market. And so, by September 15th, there were no AIGs out there, there were no protection sellers. And so I can just show the Court a couple of the communications that you'll see during the course of the trial. These are Bloomberg messages involving -- basically by Lehman. Zero liquidity in PCDS. Then by July of 2008, Megan Philbin, who was the main trader -- one of the traders for PCDS, says PCDS hardly exists.

And during that same time period, you'll see on the next slide that QVT was going out into the market -- going out to Lehman primarily and saying, we'd like to buy some more PCDS. And Lehman consistently from July to September says, we can't sell it to you. There is no AIG out there to sell protection to us, so we don't have any

protection to sell you. And the witnesses will explain how all that happened.

So, what that means is that on September 15th when some dealer is being asked to sell protection on these sort of toxic financial institutions at that time, there's no one out there to back it up on the other side of the trade. So that dealer can't go out into the market and say, AIG, please sell me protection so I can sell it to QVT. That didn't exist anymore.

So, that's why they had to go out... Morgan Stanley, for example, if they were going to replace the protection, would have to go out and sell the underlying preferred, get the let's say $6 million, and charge QVT $44 million for taking that risk on the difference.

Do you want me to...? So, there's no protection seller. So they used the par minus the value of the preferred. And I'll just skip through this because I really have taken you through this and I don't need to do it again.

The question, though, is if you're Morgan Stanley and you're being asked to sell protection to QVT on Credit Lyonnais Preferred, that dealer is going to say, okay, I need to go out in the market and sell Credit Lyonnaise Preferred. What's the price I can get for that?

So, the problem with preferred stock is unlike equities, there is no ticker, there is no -- a few of them

trade on the exchange in retail --

THE COURT: But most of them are OTC?

MR. TRACEY: Most of them are OTC. So, you really don't know what the price is on September 15th. It's dropping like a rock. And so Morgan Stanley has to say to themselves, well, if I'm going to go out in the market and sell --

THE COURT: Wait. Stop for a second. So you don't know but it's dropping like a rock? Only one of those is true. Either you don't know or you do know.

MR. TRACEY: Well, you know that --

THE COURT: You know that the common is dropping like a rock. No?

MR. TRACEY: Well, you know that the retail is dropping like a rock. Retail preferred, which trade on an exchange.

THE COURT: Okay.

MR. TRACEY: So you have to assume that the OTC is also tracking that same way.

THE COURT: You mean for different --

MR. TRACEY: For different entities.

THE COURT: I'm sorry. Okay, for different entities. So you're --

MR. TRACEY: You're just looking at the market.

THE COURT: So you're just as -- so --

MR. TRACEY: So you're saying, I don't have a firm price but I know they're dropping. Because the retail --

THE COURT: Okay, but then you have to... I mean, I don't know what the testimony's going to be, but it may be that there was a long list of reference entities -- it may be that they all were. That there wasn't a correlation.

MR. TRACEY: There's not a perfect correlation.

THE COURT: An exact correlation between, you know, a U.S. bank and a Deutsche Bank.

MR. TRACEY: That is true.

THE COURT: Or a Credit Suisse or something like that.

MR. TRACEY: That is true. But putting yourself in Morgan Stanley's position, you need to figure out if I sell $370 million of protection, how much am I going to get?

THE COURT: Right.

MR. TRACEY: And one thing I know for sure is that if I go into a small market like this and sell $370 million worth of preferred stock, the price is going to be depressed. So, Arthur Chu had to figure out how much that depression would be when he went through this exercise. And the way he did that -- what he basically said is, I could come up with a percentage number but I don't know quite would that would be. So he looked at the prices over the course of Lehman week and took the lowest closing price that

he could find during the course of that week, on the theory that if -- that the market would be lower than it was if $371 million went out into the market.

THE COURT: Okay. And that assumption or theory is challenged by Lehman.

MR. TRACEY: Yes.

THE COURT: That the transacting in that much stuff would not have affected the market or that transaction would have been -- there would’ve been a countervailing action-reaction thing that would’ve offset --

MR. TRACEY: They do show that.

THE COURT: Yeah, okay.

MR. TRACEY: So you’ll have to make that decision. I think -- well, I won’t say anything.

THE COURT: Okay. No, you think that’s wrong.

MR. TRACEY: I think it’s wrong, yeah. I mean, these are tiny markets. The amount of preferred stock that trades in a Rabobank during an entire week is less than QVT had. So they would’ve been selling into the market more preferred stock than traded by everybody else in the market in one week. So, they’re going to say it doesn’t affect the market but we’ll have to decide.

THE COURT: Okay.

MR. TRACEY: Okay, so that’s really PCDS. I can take you to CARB now. I’ll just flip through this. I just

want to -- you asked about Lehman's range. QVT valued it at 134 million. Peter Niculescu, who is the expert who went into full bottoms-up evaluation, determined that the range was between 101 and 144.

One of the things that -- I just want to highlight this because it's going to be important going forward; we don't have to go into great detail. But one of the things that he relied on was on October 1st and 2nd, Merrill Lynch actually made an offer for PCDS. They had PCDS and they were willing to sell protection.

It was after QVT finished their evaluation and QVT wasn't aware of it. This was discovered later. And so QVT did not use that bur Mr. Niculescu did, and he based his valuation of those PCDS that were offered by Merrill Lynch on the Merrill Lynch price. And there's a big dispute about what the price was that Merrill Lynch was offering. I won't go into detail. You'll hear a lot about it. But that's how Mr. Niculescu valued those six PCDS that Merrill Lynch offered. He couldn't use that for the other 13 and he developed a method of estimating the hazard of deferral and default that you'll hear a lot about.

Mr. O'Kane is the expert on the Lehman side and you'll hear his analysis. I think you'll see that Mr. O'Kane did not analyze some very critical aspects of this. He wasn't able to answer about the size of the market, the

percentage of PCDS that QVT owned, the structure of the market, who were the market makers. That didn't figure into his analysis at all, so Your Honor will have to assess the significance of that.

Okay, so turning to PCDS -- or to CARB. You've read the brief so I'm not going to repeat it. But the CARB was protection on -- it was a package of eight CDSes on separate subordinated tranches of auto-securitization. It's the most complicated thing I've ever seen. Every time I try to say it I trip over myself.

THE COURT: You got it right.

MR. TRACEY: But it's the very lowest tranches, so it's the ones that either get the losses first or soon after. And this is what these people tried.

THE COURT: You say non-pejoratively.

MR. TRACEY: And so, this again was a situation where if you look at what QVT was looking at on September 15th, there was not a single sale of protection back to July at least. So they had no prices on which to base their decisions.

The one thing that they did know, and this is the key market -- objective market indicator, on August 21st, which was what -- less than a month before, Lehman had offered protection in CARB for 23 percent of the notional amount. So that's an objective price indicator in the

market by Lehman. This is what they would've been willing to sell it for.

So, the question is what change would there be between August 21st and September 15th? Just as a reference point, during that entire period Lehman is marking it at 16 percent, which makes no sense. I mean, on August 21st they're going into the market and saying we're only willing to sell you protection on CARB for 23 percent and they're marking it in their books for 16 percent. So they're just not -- they're not relevant marks.

And so what we're looking at is a deterioration in the market between that 23 percent and September 15th. Unemployment, prepayment rates are plummeting, Ford Motor credit and GMAC is deteriorating, you've got the crisis on Wall Street. So the question is -- it's obviously higher than 23 percent, and the question is what is it?

So, what QVT -- QVT didn't have any clear indicators of price, so what they did was they started with the 16 percent notional amount that Lehman had and they said, well, the reason we went into CARB in the first place is because we had a position in GMAC that we wanted to hedge. So we bought the CARB because we believed that the CARB would go up when GMAC went down.

So they looked at GMAC, and they took the change in GMAC's CDS from September 12th to September 19th, which

increased 15 percent; they added that to the 16 percent mark, and then they said, okay, if this $80 million is a very significant amount of CARB to protect what would be the market impact of that. And they added 15 percent of that. Totally judgmental number.

THE COURT: But the CARB is made up of eight different --

MR. TRACEY: CDSes?

THE COURT: -- CDSes. Right? So, the one thing that I wasn't clear on was did they do an analysis of trading in each of those separate buckets of CDSes?

MR. TRACEY: They did not.

THE COURT: Because -- and you can tell me why I'm not thinking about it the right way. But with respect to PCDS, right, the whole methodology hinged on essentially finding substitutes in the valuation context where you had no trading in PCDS. So, okay, we can't get a quote on PCDS, no buyers, no sellers, whatever; we're going to figure out what it would take to actually acquire a short position. So you're peeling away the derivative and you're looking at the underlying --

MR. TRACEY: Obligation.

THE COURT: -- obligation. Thank you. So, here you say, okay, great. So CARB isn't trading but, look, we've got this handy-dandy list of these eight CDSes; let's

go and figure out how those are trading and we'll build up our valuation based on that. So isn't there a disconnect between we're going to do this kind of reverse synthetic exercise on the one side but we're not -- with this one product, but we're not going to do it on the other product as a response to no liquidity, no market quotation, nothing?

MR. TRACEY: Well, it's a fair question, but the problem with doing that is that if you looked at those eight underlying CDSes you wouldn't find any transactions in those either.

THE COURT: Okay.

MR. TRACEY: You could go back months and not find transactions.

THE COURT: Okay.

MR. TRACEY: So that's why they had to do it this way. Again, Dr. Niculescu looks at it and actually there was a successful market quotation by another counterparty. This is what we talked about this morning -- which Lehman produced and we're all going to talk about it. And the reason that was a successful market quotation is they did what you suggested. It wasn't a valuation of each CDS. They basically went out into the market and said give us a price on these eight individually, but as a package. Right? You can't bid on just one or two or seven; you have to bid on all of them. And three market makers did come back and

bid on that.

THE COURT: Got it, okay.

MR. TRACEY: So, we're using --

THE COURT: Yeah, I got it.

MR. TRACEY: Or Mr. Niculescu was using those prices. Mr. Bruce comes out at a very different number. He's the expert for Lehman. He comes out at 19 percent of notional. And that, in our view, just isn't consistent with Lehman having charged or being willing to charge 23 percent, and then after all the bad stuff happens, it's less value. It just doesn't compute for us.

So, that's CARB. I think we'd like to turn to the corporate and sovereign. And I'll turn it over to Mr. Reagan.

MR. REGAN: Good afternoon, Your Honor. Bill Regan with Hogan Lovells. So, Mr. Tracey told you about PCDS and CARB, which are two of the more complex and illiquid CDS debt, existed in the market back in 2008. This next distinct bucket that Your Honor asked us to deal with this morning are what you call the more plain vanilla corporate and sovereign CDS.

So, in QVT's portfolio at the time of Lehman's bankruptcy they had 596 CDS that fit into that bucket. It's a larger number of transactions but in terms of the dispute between the parties, the parties are roughly 24 million

apart on these 596 transactions.

Within the portfolio there were 462 corporate reference entity CDS on things such as American Airlines, or Goldman Sachs, or other single individual corporate entities. There were 44 sovereign CDS on bonds issued by Argentina and Ecuador and the like. And there were 90 index CDS on either corporate investment grade CDS or in this case you see here, the emerging market index that QVT had corporate CDS on as well.

Within that universe of 596 CDS the parties have a dispute about 370 of those transactions that we call the Mark-I-T transactions. Although these transactions in some sense can be considered more plain vanilla than CARB and PCDS, so can most things in that regard, but I think it’s important to take a step back and look at how pricing works in the CDS market. Because, as you’ll see, Lehman’s experts in this area tend to treat these CDSes as something like widgets or even just common equities, where you can determine the value if all you know is the name of the reference entity or the name of a ticker in the case of an equity.

So, this chart here shows the different types of CDS that you could have with respect to American Airlines alone. If you want to know how to value, or price, or trade a CDS it’s important to look at all six of the columns or

all six of the factors that drive pricing that are listed in this chart here.

So, the first one obviously is the reference entity. You need to know what the reference entity is and pricing varies significantly. If we're talking about September 15, 2008, the CDS on Morgan Stanley, which was on the verge of bankruptcy, it's going to be priced very differently than a CDS on American Airlines. So the reference entity is obviously very important.

The maturity date is obviously critical. If you are offering CDS protection for a one-year term, you might charge a very different price than you would if you were going to be on the hook for ten years. And CDS come in every variety in between. And it's important to note, and this'll come up later, that back in 2008, there was a market convention or a market standard that the typical CDS was the five-year variety. And that will come up over and over again. You'll sometimes hear that referred to either by the witnesses or in the document as an on-the-run CDS, the five-year variety.

The notional size is obviously key in terms of the valuation, the pricing of CDS. If you are going to insure somebody for a million dollars in exposure, that's one thing. If you're going to provide $20 million in CDS protection, that's obviously something very different from a

pricing perspective. So you need to know the reference entity, the maturity date, and the size of a trade before you can make any reasoned judgment as to how to quote a CDS or how to purchase a CDS for that matter.

THE COURT: Are you saying that -- or implying that the expert, Lehman's expert did not take into account any of these other than -- any of these columns other than what the reference entity was?

MR. REGAN: They looked at the reference entity and then only the five-year single names. So they excluded indices, they excluded any CDS that was a one-year, a three-year, a seven-year, or a nine-year, which were, as we'll see shortly, a significant part of QVT's portfolio.

THE COURT: Okay.

MR. REGAN: In terms of the notional size, too, it's also important to note that there were conventions in that area as well. A typical CDS back in 2008 for an investment grade CDS was typically a $5 million transaction; for a sovereign CDS the standard size was typically 10 million; and for an index, the standard was roughly 25 million. And you can have any variation in between but those were generally the conventions that market participants thought about back at that point in time.

The other factors that you see listed here, restructuring clause, currency, and seniority certainly

affect pricing in the CDS market. A restructuring can trigger a CDS contract, and within the marketplace there are four different clauses that parties use, some of which make it easier for a restructuring to trigger a CDS contract and some of which make it more difficult for a restructuring to trigger the contract.

And so depending on how easy that is, that affects the pricing as well. Certainly the currency that you use impacts pricing, and whether you're providing CDS coverage on a subordinate bond, more at risk would affect the pricing, as would whether you have coverage on a more senior bond, which would make it safer.

The other thing to keep in mind is that all of these transactions happened in an over the counter market. This is not the New York Stock Exchange, so there is no automated matching of buyers and sellers. If QVT's out in the market, they can't go to the exchange and get hooked up with a corresponding counterparty; they have to do that legwork on their own.

There is no ticker or tape. So folks like QVT can't look at their Wall Street Journal screen or their Bloomberg screen and see that other participants have traded these CDS at particular prices. It's essentially a dark market.

The volume is much smaller than the New York Stock

Exchange. You'll see evidence in this case that the -- in the New York Stock Exchange there were as many as 15 million trades in a given day, whereas in the CDS market in 2008 there were on average 3,000. So in terms of the overall transaction activity it's a much smaller market.

And, of course, there's no open or close as there is in the exchange market. Sometimes CDS transactions happen at 4 o'clock, 5 o'clock, 6 o'clock -- it depends on when the traders go home. But there's no formal market close.

So, in terms of QVT's process, Mr. Tracey earlier discussed sort of a hierarchy of price sources that QVT looked at. With respect to these Mark-I-T transactions, where are in that hierarchy is that these are transactions all of which the market quotation process failed. QVT did not receive free quotations for any of these. They did not execute replacement trades for any of these, so they were essentially doing a valuation exercise in late September on the two weekends that Mr. Tracey mentioned.

So what they did was follow a two-step process. First, they looked at the Mark-I-T closing bid for each stage during Lehman week. And knowing their positions and the drivers of pricing that we talked about earlier, they made a judgment as to which price best reflected their replacement cost had they been able to execute the trade.

THE COURT: So, let's pause on that one, though. So, market quotation failed. And they're not calculating at the end of the day on the 16th. You have said undisputed that it was on the weekends, right?

MR. REGAN: Yes.

THE COURT: So, you're already -- so you're out of Lehman week, you're on to that first weekend. But you've terminated -- your ETD is September 15th. You went out into the market on September 15th, you did or did not get answers on September 16th. Definitely by September 17th, say, anyone who was going to quote was -- will have quoted.

So, why would you be looking at Mark-I-T data or any other Markit data for dates subsequent to just, say, the latest, the 17th? Why should you be looking at data on the 19th when that was at the end of Lehman week, a very long week -- lots of stuff had happened in the markets every which way?

MR. REGAN: So, they almost -- for the vast majority of these transactions they used September 16th; for another significant chunk they used September 17th.

THE COURT: Right.

MR. REGAN: I think it's probably true -- and we'll have a slide on that in a minute where they used September 19th. And I think both of those prices were more favorable to Lehman than they were to QVT. If they'd picked

a different date that week, QVT would've done better.

THE COURT: Okay.

MR. REGAN: But we'll show you date by date which dates they used for these transactions.

THE COURT: So that was out of the goodness of their hearts?

MR. REGAN: No, they were trying to be reasonable. They were trying to figure out their replacement costs, and that was really what they were doing. Which date best reflected our most likely replacement costs given the chaos in the market and what we know about our positions.

So after they picked that date, they knew that Mark-I-T was a mid-price and they were trying to figure out the replacement cost. So we needed to go from mid to offer. So they added a spread to that, and we'll show you that in just a minute.

So this slide shows the breakdown and the 370 transactions at issue, and which date during Lehman week QVT used. For 260 of the transactions they used September 16th, which was the very next trading day. For 28 transactions they actually used September 15th itself because they thought -- they looked at the prices and they thought we probably could have traded on that day. And then for a smattering of other transactions they used the 17th, 18th, and 19th for roughly 75 or so. And that's the date

distribution, but you'll see there that 260 transactions were the very next trading day.

In terms of the spread that they added to get from the Mark-I-T mid to the offer price, they used a range of spreads going from 3 percent to 15 percent with the vast majority of those being valued at 10 percent, which QVT used as something of a default assumption. And traders varied that up or down depending on whether they thought the position was more liquid or less liquid. You see they varied that -- the used 3 percent for 48 trades, 5 percent for 10 trades, and 10 percent for the bulk of 288 trades, which was 77 percent of the universe of transactions.

So, Lehman objects to both of those steps -- both the use of the Mark-I-T dates and the spread as well. In terms of the valuation date issue, Lehman makes essentially the playing the market or moral hazard argument that Your Honor mentioned earlier. They call it cherry-picking, and they introduced testimony of -- they will introduce the testimony of Justin Garzia on that point.

Mr. Garzia was a CDO trader at Morgan Stanley during September 2008. And he will opine based solely on the date distribution that we looked at, that QVT was engaging in a cherry-picking exercise to inflate its claim. He doesn't really tie a number to that particular line of argument. He makes the allegation of cherry-picking and

throws around that word because there are different dates involved. But he doesn't tie in economics to that argument.

The argument that he does use for that is that, in his view, Mark-I-T pricing from September 15th was no less reliable than Mark-I-T pricing from any other date during Lehman week. And so, therefore, essentially, QVT was required to use 9-15 for all the transactions. And any time they deviated from 9-15 they were inflating the claim. So that's how he calculates his $13.6 million inflation number for the cherry-picking part.

Professor Engle is an NYU professor that Lehman will introduce to talk about the spread issue. Professor Engle is a finance professor at NYU and he won the Nobel Prize in 2003 in economics for something called ARCH.

THE COURT: Yes.

MR. REGAN: A-R-C-H. I will not try to --

THE COURT: You can't try to say what it is.

MR. REGAN: Autoregressive Conditional Heteroskedasticity. If I got that right -- I'm not sure. Don't make me do it again. Let's go with ARCH on the transcript.

THE COURT: Do you want to just briefly explain what it is for everybody?

MR. REGAN: Yes, once I get back from MBA school I'll construct -- try to explain that. But, thankfully,

that has nothing whatsoever to do with this case. What Professor Engle does is much more common regression analysis. And through his regression analysis, he reaches two conclusions: One that QVT's spreads were not consistent with what the CDS market as a whole was seeing in 2008. And then, second, that QVT spreads were not consistent with what the market was paying for the reference entities that QVT had in its portfolio in 2008.

THE COURT: And what's wrong with that? What's wrong with his conclusions?

MR. REGAN: Oh, can we get to that in one second?

THE COURT: Sure.

MR. REGAN: Let's check on Mr. Garzia first because I know Your Honor was concerned about the moral hazard issue and the playing the market issue. And I think there's some very strong data that can put that in the proper context.

The reason that QVT used September 16th for the vast majority of these positions was that the market quotation process on September 15th failed. So there's some strong pricing indication from the market that the market was not interested in QVT's positions on the 15th. And then from a timing perspective, that process failed at the end of the trading day. So the earliest point in time when QVT could begin to replace most of these positions was after

that process had failed.

And so those two things together led most of the QV traders and for most of --

THE COURT: But the process didn't fail at the end of the trading day. Because according to Mr. Tracey, QVT still was willing to transact or that the market understood that it could respond and by implication transact on the following day. So the end of the trading day really didn't have any impact on that, right?

MR. REGAN: Not so much the end of the trading day. The end of that calendar day, some of the pricing that Mr. Tracey referenced earlier today came in very late that day.

THE COURT: Sure.

MR. REGAN: Some more trickled in on the morning of the 16th but I think it was only a handful of responses. I think it was pretty evident to QVT that the process had failed by some point late on the 16th.

THE COURT: On the 16th.

MR. REGAN: On the 15th, sorry. And so the assumption was that the very next trading day would be the earliest point in time when QVT could go out in the market and actually do these trades. So, for the vast majority they used September 16th.

They deviated from that only when individual

traders thought that the Mark-I-T price on some other day better reflected when QVT could've actually effectuated a replacement transaction due to liquidity concerns or whatever the case may be.

I think it's important to note that -- and Mr. Tracey alluded to this earlier -- Lehman doesn't object to actual replacement trades that QVT entered on September 16th; it's only the use of hypothetical trade in the Mark-I-T price on 9-16 that they object to it, and there seems to be some inconsistency in that position.

Dr. Diplas, who is QVT's expert and was a CDS trader at Deutsche Bank for many years, including having responsibility for preparing Deutsche Bank's claim against Lehman during the bankruptcy process will testify that in his view it would have been highly unlikely that QVT could've replaced these trades, all of them on the 15th.

So, in terms of the playing the market idea, Mr. Garzia, all he does is look at the dates. And he said, I see different dates; therefore there's cherry-picking. But he doesn't do any further analysis. He stops right there.

The data on this slide shows -- is data taken from Mr. Garzia's own backup spreadsheets. And what it shows is the value he calculated for five of the CDS within 370 Mark-I-T transactions. And if you go through those dates you'll see that in some instances QVT picked a date where the price

is most favorable to QVT; on other instances QVT picked a price where the date is more favorable to Lehman, and on many they picked the date in the middle.

So, for example, you'll see in CIT Group, QVT used September 16th, and that's the lowest value during Mark-I-T, and that's the date QVT used in its claim.

For the bottom CDS, HCA Holdings, QVT also picked September 16th. That turned out to be the most pro QVT value available during Lehman week. And for the three transactions in the middle, Alcoa, Genworth, and General Motors, QVT picked a middle price, neither most favorable to Lehman nor most favorable to QVT. So you can go through this analysis for all 370 --

THE COURT: Just to stop. Can you go back?

MR. REGAN: Yeah, sure.

THE COURT: So, just out of curiosity, and bearing in mind the appropriate interpretation of loss and it has to be reasonable, not best or not perfect, is there a thesis or an understanding of why it would be that just across this set -- what caused whoever did this valuation to pick the 17th as opposed to the 16th in terms of thought process or analysis that was done at the time?

MR. REGAN: It was trader by trader. So QVT broke the positions out to each individual trader who had made that transaction. And that trader looked at the position.

And based on what they knew on the market, they looked at a price on the 16th and said, we know there are many other trades that day -- or in our view, we had such a big position that we could not have transacted at that price. The 17th is more realistic from a volume perspective, where we could've gotten a trade out. It was sort of case by case and position by position where they deviated from the 16th, which was more or less a default assumption.

THE COURT: Go ahead.

MR. REGAN: So if you repeat that analysis all 370 positions in the Mark-I-T transactions you see that in 38 percent of the cases QVT selected the date that was most favorable to QVT, which is one issue. And then for 62 percent of the transactions, QVT selected either a date most favorable to Lehman or a date in the middle between the two extremes.

So, either QVT wasn't cherry-picking to inflate its claim or it wasn't doing it very well is the point of the day.

THE COURT: But then the adjustment from mid is --

MR. REGAN: That comes next.

THE COURT: -- is a separate component?

MR. REGAN: Totally separate component.

THE COURT: Okay. So it doesn't -- there's no necessary correlation on what the adjustment to mid was

based on whether or not it happened -- you're adjusting a price most favorable to Lehman or most favorable to QVT, right?

MR. REGAN: No. Totally separate.

THE COURT: Okay.

MR. REGAN: So, the second opinion that Mr. Garzia makes is that essentially QVT was required to use 915 Mark-I-T data for all of the transactions because in his view the pricing for that data -- for that date was no less reliable than the price available for Mark-I-T for any other date during Lehman week.

And then any time QVT used the September 16th or September 17th, he calculates the difference between the 9-15 price and the 9-16 price and says that's an inflation. So, but he does this just based on his sense of the market. And his recollections from 2008 were that 9-15 Mark-I-T data was just as reliable as Mark-I-T data from any other point in that week.

He didn't test that proposition in any way, he didn't support it with any data, he didn't break it down position by position; he didn't look at whether Mark-I-T for Morgan Stanley and Goldman Sachs, which were teetering that day, were just as reliable as Mark-I-T for Burlington Northern Railroad or American Airlines, or some of the referenced entities that were obviously less affected by the

financial crisis. He didn't go to that level of detail. It was just his hunch and his recollection.

When Mark-I-T collects contributions from dealers and then they publish a composite price both on the incoming side and the outgoing side they do some data analytics to identify the data as potentially unreliable. For incoming contributions from the dealers they might designate a mark as an outlier because it's outside what other dealers are doing, or it's stale -- it looks like it hasn't changed in some time, or it's a carryover price from the day before. And so that kind of data is available in the Mark-I-T data that Mr. Garzia had available to him when he read his report. He didn't really look at that.

On the outgoing side Mark-I-T when they published a composite number, Mark-I-T will identify the number of contributors to that mark. And so a mark that has 30 contributors might be considered more reliable than a mark that has two contributors to it. And Mr. Garzia didn't look at that either.

In some ways his opinion is just contrary to common sense. 9-15 was one of the craziest days in market -- with an E -- market history. Lehman had failed, Morgan Stanley was on the brink, Goldman was on the brink, many dealers were either worrying about their own solvency or their own Lehman exposure and getting around to putting a

nonactionable price over to market at the end of the day was not high on the to-do list in many cases.

THE COURT: Ah-ha. But you see, Lehman will say that that's precisely why QVT put out their market quotation process when they did, because they knew that, in effect, they were asking for nonactionable trades.

MR. REGAN: I think if you look closely at the market quotation that Mr. Tracey put on the screen earlier, there are actually two pieces to it. QVT at the top asked for actionable prices. Give us bids for these positions that we can transact on.

THE COURT: Right. Which is what market quotation requires under the ISDA, right?

MR. REGAN: Right. But they also knew -- and they wanted the market quotation process to succeed. They knew that people were busy that day; they knew it was a crazy day in the market. So, at the bottom of that market quotation request there's a proposal that says if you cannot provide or won't provide actual actionable bids, please provide a curb marked as follows. So, to make the process work they offered both options to the dealers.

So, now, moving over to the spread issue, the traders in this space tend to use spread in 19 different ways and it's tough to follow. So, for this particular spread, I just wanted to go through some of the terminology

here. The screen shows basic bid and offer scenario. The dealer offers 90, will buy its protection at 90 and the dealer will sell protection at 110. That makes a bid offer spread of 20 and the midpoint 100. The mid is what Mark-I-T puts out at the end of the day, that midpoint.

The mid offer spread, the distance from the mid to the offer is 10 and also it’s 10 going the other way -- the bid mid-spread is 10. What we’re talking about here is since QVT was primarily a protection buyer -- we’re talking about the mid offer spread.

So, even though that’s what we’re talking about, you’ll see the expert talk about bid mid spread, but we’re talking about the distance from the mid to the offer. And that’s typically presented as a percentage.

THE COURT: So you’re saying that when they say bid mid, they mean mid offer?

MR. REGAN: Mid offer, yeah. Everyone means mid offer but they use bid mid, mid bid, all different things. But we’re talking about the mid offer. Expressed as a percentage over the mid, so in this case it would be 10 percent.

As we noted, QVT added a range of spreads. It could’ve been 3 percent, 5 percent, 6 percent, 10 percent for the significant majority of the positions, and 15 percent for a handful of more of the liquid positions. QVT

trader did that by looking at the same drivers of pricing that we talked about. What is the reference entity, what is our notional size, what is our sense of the market's demand for this product?

Professor Engle doesn't really challenge any of that; he just does a fundamentally different approach. He offers his regression analysis, which I'm sure the Court is familiar with. It's a relatively common mathematical tool used for lots of different purposes in litigation. And it's generally accepted by courts if done properly. And we'll explain why that wasn't the case here.

So, Professor Engle first purports to analyze the entirety of the 2008 CDS market, and he looks at primarily two things: What dealers like Lehman were quoting to end users like QVT for CVS transactions. He calls that his quoted bid mid spread. And then he looks at what end users were actually paying to dealers and he calls that his effective mid bid spread.

THE COURT: Right.

MR. REGAN: And he largely proceeds from the assumption that end users can negotiate the spread down. The spread is -- the quoted bid mid spread is something like a sticker price, and if you haggle hard enough you can pay a lower price at the end of the day.

THE COURT: Hold on one second. I just want to

get his report. Okay.

MR. REGAN: He actually does four metrics. He does another one called inside market bid mid spread and realized bid mid spread. But those are more subsidiary analyses that don't play as prominently in Lehman's pretrial brief.

On the two analyses that do -- the two that seem to be the most important, he concludes that the quoted bid mid spread for both the market-wide analysis and for QVT's portfolio was less than 4 percent. And in terms of the effective bid mid spread where folks were actually paying at the end of the day, that number is less than 2 percent in Professor Engle's view. And so from that, Lehman will argue that QVT's range of spreads going from 3-15 percent was excessive and too high in roughly the amount of 10 or $11 million.

As I mentioned before, courts have frequently accepted regression analyses to support expert opinions, but courts also recognize that regression can be an abused mathematical tool if not done properly.

MR. REGAN: ...have frequently accepted progression analyses to support expert opinions, but courts also recognize that regression can be an abused mathematical tool if not done properly. And particularly when one of two things happen; when the analyst in advance of running the

regression rigs the outcome by selectively choosing the data that goes into the model. You can get a biases outcome that's so biased that it has no evidentiary value to either scooted entirely or reported no weight.

And the second reason is when the analyst looks at a problem and ignores known explanatory variables. So, for example, if you were talking about a discrimination case and you wanted to know were all the employees of a corporation who were -- had the education and the same ability were being compensated similarly, but you left out their experience. That would be a major problem because experience affects compensation, so you would exclude a regression analysis that leaves out known explanatory variables. Professor Engle's analysis, as we see, will suffer from both of things. He rigs the outcome before he runs the analysis and he ignores known explanatory variables when trying to figure out what end-users pay for CDS transactions in 2008.

I struggled with this when I first read Professor Engle's report. Why is he doing a regression analysis in the first place? Why not just look at what the quote was from the dealer to the end-user?

THE COURT: That's my question and I --

MR. REGAN: It's a good question.

THE COURT: Well, you know, when I looked at the -

- his -- the figures, it looks more like that then an actually regression analysis, but --

MR. REGAN: There are different ways to look at it.

THE COURT: Okay.

MR. REGAN: The problem is that the DTCC data set that Professor Engle starts with -- DTCC is the Depository Trust and Clearing Corporation.

THE COURT: Yeah.

MR. REGAN: They have kept a record of what may be all CDS transactions from 2008. People reported their trades to DTCC --

THE COURT: Right.

MR. REGAN: That data set is not public. No one can access that. The only reason we have it in this case is through the power of a subpoena that Lehman issued. So QVT could not have looked at that data in 2008 when calculating their claim. But Professor Engle looks at that data and he wants to find out what was the quoted price for those trades and what was the executed price and he wants to compare them. The problem is that DTCC data doesn't record the quoted price. All you have is the actual executed price. So he needs to go to some other source to find a quote and then try to find a way to tie it to the DTCC data.

The only way to really do the analysis that he

purports to do is to take discovery from all 866,000 trades that happened across the market and find out; did you get a quote from Morgan Stanley? What was that quote? What was your final end price? Was there a difference? But he can't do that. That's 866,000 trades, so he tries to substitute in the regression analysis.

THE COURT: I see. Okay.

MR. REGAN: And the way he does that is trying to tie these three separate data sources together. So he starts out with DTCC, which is non-public actual executed trades from 2008. There are limitations and imperfections with that data set. Reporting to DTCC was not mandatory. Nobody in the 2008 CDS market had to send their trades to DTCC. It was a widespread practice. Many market participants did, but no everyone. So we don't know how complete the DTCC data set is. CMA is a completely separate corporation. They have a software product that market participants use and used back in 2008 to search their Bloomberg messages and their emails for broker runs . And those brokers runs don't specify typically notional size and maturity that what brokers send out and say, "We see this reference entity at this -- in this offer call if you want to do a trade." but you can find some quote information in CMA, but it's not tied in any way to the DTCC data. It's a completely separate business and a completely

separate company.

And in the last piece of data that uses is the closing mids  from Mark IT and this is where you get deep into the regression analysis.  He needs to use that price to come up with first day profit and loss.  Essentially replace the fact that he doesn't know what the actual quote was, so he needs to sort of estimate it through the regression analysis.

But in terms of rigging the analysis, Professor Engle did not look at the 866,000 trades that happened through 2008.  He applied a series of filters that knocked that data set down dramatically, and in a biased way.  The first thing Professor Engle did was exclude all trades except for corporate single names.  So he didn't look at indices in any way, shape or form.  The next thing he did and this is particularly material, he excluded all trades that were not at the five-year maturity and the five-year maturity is that standard that we talked about earlier that is more frequently traded than any other maturity.  So by definition, took out the less liquid transactions.  He also excluded all trades that were not quoted in the run/spread convention that Mr. Tracy talked about earlier and that means the upfront point spreads and those were the riskier entities where the reference entity was under some kind of stress, which by definition will tend to have wider spreads.

And then because he was focused primarily on a consistency issue, rather than a representative of the market issue, Professor Engle excluded from his data, any trade where he could not find a corresponding quote on that reference entity on CMA and then, also a Mark IT closing mid. So unless he had a three overlap in his data set, he just pretended that, that trade didn't happen. And then lastly, when he was running his data through Lehman Bloomberg's calculator, if that calculator needed more information or didn't -- their information wasn't reported to DTCC in a way that the calculator could pump out a value, he excluded that data as well.

So as you see in the diagram here, what he doesn't do is look at the 2008 CDS market, he looks at this very narrow overlap where CDS, DTCC, CMA and Mark IT have a data point in common. And so the effect that, that really is, is rigging out. He did not in any way look at the 2008 CDS market. In fact, in those filters that we just described, he took out 87 percent of the trades that happened in 2008. He started with 866,000 trades and ended up with 114,000 trades. Those trades that he excluded really happened. They're real trades that market participants did in 2008 that had a quote that had final purchase prices. They were real, so you can't opine on the market and exclude 87 percent of the market. It just doesn't make any sense. In

terms of the quotes, you see the same effect of the filters. He had 49 million quotes in the CMA data which are the filters he excluded 30 million of those quotes getting down to 15 million.

We talked about the result that, that what's left is heavily biased to show -- is the heavily traded five years to show small spreads. So, not only did he not look at the market, he also rigged the outcome by not looking at QVT's actual portfolio. And his report gets very confusing and it took me 15 or 20 reads to figure out what he did for the QVT portfolio, but the first thing he does is the market wide analysis and after he completed the market wide analysis, Lehman gave him a list of the reference entities that were in QVT's portfolio and he scanned his filter data set for data points on just those reference entities that were in QVT's portfolio and he scanned his filter data set for data points on just those entities and then recalculated his numbers. It came up something similar, 4 percent for quoted and 2 percent for effective, but what he didn't do is look at the CDS drivers pricing that we started with. He didn't look at QVT's portfolio. He didn't look at the notional size of the positions. He didn't look at the maturity of the positions. He didn't look at the restructuring clauses of the positions. He didn't do any analysis of QVT's (indiscernible ). He just looked at his

data set for points that happened to be there. So he just can't say that he looked at QVT's portfolio and I think the best way to illustrate that is to look at applying his filters to QVT's portfolio.

So we started out with 596 corporate and sovereign CDS in QVT's portfolio and the first thing Professor Engle does is exclude indices. Indices were gone. There were 90 in QVT's portfolio and that gets you down to 85 percent. Then you exclude any transactions where you can't find a three-way overlap in the data sets. QVT has 120 positions where you couldn't find a corresponding quote in CMA. That gets you down to 386 positions or 65 percent of the portfolio. And QVT's portfolio was primarily non-five-year and Professor Engle exclude non-five-year, so if you apply all those filters to QVT's portfolio, you get down to 36 positions. Professor Engle filtered out 94 percent of QVT's portfolio.

So the threshold question that we started with, why is he doing this regression analysis; why not just look at what was quoted and what was paid is interesting. I think the answer is probably because the data isn't helpful. If your assignment was measure what was quoted for its positions in 2000 (during Lehman week) and what QVT would have paid to replace those positions during Lehman week, we have some pretty good data on those points. The first is

the DTCC data set, which is -- are actual executed trades, both all of September 2008 -- all 2008; all of September in a particular Lehman.

So this chart shows sampling of positions that were in QVT's portfolio. The first three columns show the reference of any that QVT had; the specific maturity bucket for that position; and the notional size of QVT's position. So these are positions that QVT was trying to value and figure out how to determine the replacement costs. The next five columns show the total amount traded for those positions throughout Lehman week, so, for example, if you look at Radian Group, you'll see that QVT had a four-year mature -- four-year CDS for Radian and they had $27 million in notional value for Radian. On September 15th, the day of Lehman, the entire market traded only $11 million in that position, so how could QVT find a replacement seller for $27 million? The entire market, including every other hedge fund or end-user that lost their Lehman exposure -- Lehman position that day were out there trying to find positions.

Professor Engle didn't look at any of this data. He didn't look at the positions, he didn't look at the value, he didn't look at the relevant data. Some of the extreme examples and Your Honor is a fan of extreme examples, the gin works seven-year. I think is a good one. QVT has seven years -- a seven-year maturity from that CD.

They had $9 million in total notional. No one in the market traded that security at any point in time during Lehman week. So, in some sense, by choosing a price from Lehman week, QVT was being generous to Lehman because no one traded at that point in time, so they could have come up with another methodology, but they used the process that we've talked about.

A few other interesting points in the data to see the Goldman Sachs position -- the two-year Goldman Sachs position. They had $20 million that day. September 15th, nobody traded Goldman Sachs two-year, obviously, because Goldman Sachs was on the brink that day. People were worried about Goldman going under, so providing CDS protection on Goldman Sachs that day wasn't a particularly appetizing investment.

The other data point that Professor Engle ignores that's quite compelling are the actual quote that QVT receives. So although the market quotation process failed, that does provide some contemporary evidence of what the spreads were; what QVT was really being quoted for its positions at the relevant point in time. Professor Engle did no analysis of those quotes. I don't even think he was aware they existed, so we had our experts look at those quotes, essentially do what Professor Engle did, compare them to the Mark IT mid and all of those quotes show that

QVT was sharing spreads of 20 to 22 percent that day.

THE COURT: Just to be really annoying or to show you that I'm actually paying attention --

MR. REGAN: No doubt.

THE COURT: The slide on the screen is numbered 123 and the slide that I'm looking at is number 120, so there appears to be a discrepancy --

MR. REGAN: The hard copy slide is 120?

THE COURT: Yes. So there appears to be a discrepancy and we can figure it out --

MR. REGAN: Does your screen look like that?

THE COURT: Yes. No. No. So that's 119.

CLERK: Right.

THE COURT: This is 119 in my book. This little number down here says 119 and the one on the screen says 123.

MR. REGAN: Where did I lose you? Did you have that one?

THE COURT: I -- you know, I'm not going to answer that question. You're doing great.

MR. REGAN: Oh, that's brutal.

THE COURT: All right. You're doing great, but just that somebody should reconcile just so the record is clear which deck we want in the record. Okay?

MR. REGAN: Let's use the monitor then, if that's

the one that's working.

THE COURT: The monitor, okay.

MR. REGAN: So this data here shows what the spreads were based on the market quotation responses that QVT got on September 15th and into the next day on the 16th. If you compare those market quotation responses to the Mark IT mid for those days, these are the spreads that you see. So on Lehman day and the next day, QVT was seeing spread in the market in excess of 20 percent, which strongly suggests that their 3 to 15 percent range was reasonable.

The other reason that courts exclude or put no weight on regression analysis is when the analysts ignores obviously known explanatory variables that help inform the problem. So all Professor Engle looked at was the quoted price and the ultimate paid price. He didn't look at any specifics among the referenced entities. He didn't analyze whether pricing might be different for Morgan Stanley versus Burlington Northern. He didn't look at whether pricing might vary among different counterparties. The C -- CDS market for people like Black Rock or Fidelity, very different from the CDS market for hedgers like IBM or Exxon, and that in turn is very different from the CDS market for hedge funds like QVT. Professor Engle made no effort to account for the different prices paid by different kinds of market participants. He didn't look at the notional size of

the trades in any way and he didn't look at anything other than the five-year standard contract.

Let's take -- Dennis is going to talk a little bit more about some of Lehman's objections that didn't, unless Your Honor has any other questions on the plain vanilla stuff.

THE COURT: Thank you very much.

MR. TRACEY: I have good news.

THE COURT: You settled?

(Laughter)

MR. TRACEY: No, no, no, no, no.

THE COURT: It was worth a try.

MR. TRACEY: We've covered the objections in the course of our conversation --

THE COURT: Okay.

MR. TRACEY: -- today. Most of them. There's possible one that we haven't covered, but I think in the interest of time, I'm going to pass the baton to Lisa Combat.

THE COURT: Okay, that seems like a good idea.

MR. TRACEY: So, thank you.

THE COURT: Okay, thank you very much. All right, why don't we take until 10 minutes after 3:00 and then we'll go until 4:30. The shipping will have been told to quietly make their way in and we'll do a quick switch at 4:30 and I

would ask you to stay. We're going to have a switch of a reporter at 4:30 as well and I'm willing to stay, you know, until 5:30, 6:00 today in the hopes of getting openings done. All right? Sound like a plan?

UNISON : (Indiscernible)

THE COURT: By the way, I neglected to say again, I think I said it during pre-trial conferences that during long trials like this, the no coffee and soft drinks rule is waived. You're allowed to bring in coffee and soft drinks. I just ask that you clean up after yourselves at the end of the day. All right?

Yes, there's a question from the gallery. Sir?

MAN: I'm just making sure our gear is going to be okay here in the courtroom.

THE COURT: Yes, so just -- you don't have to move anything. I'm just going to ask the people at the counsel table to tidy a little bit, but obviously, if there's anything sensitive that you don't want somebody to inadvertently see, just turn it over or whatnot, but we've told the folks who are coming in at 4:30 to sit quietly in the back. All right.

MAN: That's about it, Your Honor.

(Recess taken at 3:02 p.m.; resume at 3:17 p.m.)

CLERK: Please have a seat.

THE COURT: Mr. Tambe, how are you?

MR. TAMBE: I'm fine, thank you, Your Honor. Got a little bit of a frog in my throat, so (indiscernible ).

THE COURT: You need a lozenge?

MR. TAMBE: No, I have one.

THE COURT: Oh, okay. All right.

MR. TAMBE: (Indiscernible ).

THE COURT: Okay.

WOMAN: Every trial, there's lozenges there.

MR. TAMBE: Every trial, (indiscernible ).

THE COURT: It's a trick they employ. It's like a sympathy thing, you know.

CLERK: One for the court reporter and what we're taking (indiscernible ).

THE COURT: Thank you. For the benefit of the QVT people, I know I've said this before, but one of my coping mechanisms is just to lighten up a little, but please this is entirely serious, apropos what Mr. Tracey said. So I just don't want you to leave and say, you know, she's making jokes about this. I'm not. It's just a coping mechanism, otherwise, I would be able to cope with this trial. Okay, ready when you are.

MR. TAMBE: So what's at issue in this case? The way QVT has described it, the only issue in the case is ether QVT valued the QVT transactions reasonably and in good

faith, which prompts us to ask many questions, right. Was it reasonable for QVT to ignore its own valuations from 9/15? They had been valuing these transactions from an extended period of time. They valued them day-to-day for collateral purposes and they valued them at month end with their auditors for (indiscernible ). So there was an understanding of what the trades were. There was an understanding of the liquidity; a lack of liquidity of these trades, including, I think you saw some slides that showed you that in some of these transactions they were well aware that there had been no significant liquidity in the market, 2007, 2008.

So the lack of liquidity was not a sudden new occurrence, so was it reasonable given all of those facts and what they knew about these trades to ignore their own valuations for 9/15? Was it reasonable to ignore available market data from 9/15 and we'll get into this in more detail, Your Honor, but there was an extended discussion about the Mark IT transactions --

THE COURT: Right.

MR. TAMBE: -- and every one of the traders justified, yes, Mark IT data was available on 9/15, but it wasn't used. They decided to use 9/16, 9/17 or some other date, right. Was that a reasonable departure? Does the contract permit such a departure and what's the effect of

such a departure? Which really prompts the question, hundreds of transactions were valued after the early termination. Was it reasonable for them not to solicit quotations on all transactions? What you heard today and I think what you've seen in the brief, it was a mistake. Perhaps, but it goes to a broader point. It goes to the level of care in analysis that was put into the market quotation to begin with. This is not an unsophisticated counterparty. As you'll see and I'll go through some slides here. This is a counterparty that had a very good handle on what its positions were. Even before Lehman filed for bankruptcy they had a running internal analysis of, "Hey, what's our exposure to Lehman? If Lehman were to fall over, are we exposed?" They knew what their transactions were and yet, for whatever reason -- there's no explanation given, but 44 trades are just missed, including some very liquid names and we'll talk about those 44 trades.

THE COURT: So are you suggesting that it wasn't just an accident, just an oversight?

MR. TAMBE: I think I'm suggesting it is part of a lack of due care in running the market quotation process. The contract says you're supposed to run the process in good faith and you would expect that a party that is obligated to run a market quotation process and has that flexibility to pick the as of time in good faith, would give some thought

on analysis to, "Are we in a position to run this process? Are we running this process adequately? Do we have the trades?" It is part of that overall story. All right, you can't just look at the 44 and say, "Well, we just happened to miss the 44." And there's many other reasons why the stories we're now hearing about the 44, that it was just a mistake, don't seem to add up.

THE COURT: So what's Lehman's position and this is maybe small compared to the rest of the exposure, but Lehman's view of those 44 is that, therefore, they -- QVT should not get to revert to loss --

MR. TAMBE: That's right.

THE COURT: -- because there was no market quotation failure, as that term is used in the ISDA , so, therefore, the measure of damages with respect to those 44 non-existent market quotations is to reconstruct what the market process would have yielded had they run it, or that their claim is disallowed.

MR. TAMBE: But there is a value that is in QVT's books and records for those 44 transactions and that would be a reasonable number for Your Honor to look at, as the value at which they carried those positions. I know there's case law up there and we -- in the Oppenheim --

THE COURT: Well, there's the Oppenheim case.

MR. TAMBE: The Oppenheim case that says redo the

market quotation.

THE COURT: Right.

MR. TAMBE: and it may be the case that once we're done hearing from all the experts and all the witnesses, when we're talking about the legal causes of action and the legal remedies, we will be talking about what options the Court might have to resolve that particular issue --

THE COURT: Okay.

MR. TAMBE: -- with respect to 44, or consider the 44 as part of their overall approach to the market quotation process and reach some other conclusion as to whether not they ran the process in good faith and reasonably.

THE COURT: So one bad apple could spoil the whole bunch?

MR. TAMBE: Well, one bad apple with other indicia of a lack of care and interest in good faith and reasonableness in running the process. Was it simply an exercise in futility, which is send out a request for quotations late in the day. Give people an hour to respond, 40 minutes to respond and we'll get into the details of why we believe and they believed at the time that, that was the deadline. They're arguing differently now. It's all part of is that a -- was that a reasonably run market quotation process, right? Was it reasonable to adopt untested valuation methodologies? This harkens back to the

discussion we had at the beginning of the day, today, which is, what was the analysis that was really done when QVT decided, "Well, we're not going to use the metrics we've used before. Maybe those data sources are not available to -- we're going to do something different." What, if anything, did they to do to satisfy themselves that, that was a reasonable way as opposed to a maximizing way of doing the calculation? Was any such analysis done? We submit no such analysis was done.

That, what seemed to be the driver for that part of the calculation and many other parts of the calculation was to maximize, or to certainly inflict, if not to out drive maximize. In the case of PCDS, it seems like it was to maximize it. It was to pick the lowest point of the week looking back weeks later. But that doing a backward exercise and say, "We're going to pick the lowest point of the week and we've seen what's happened to prices of preferred securities. They've gone down and they've come back up. We're going to pick the lowest point. Was it reasonable to tack on millions of inflated charges? And this is -- this is going to get to a fundamental question, I think, under loss. I believe you asked a question of counsel for QVT. The loss definition on its face doesn't say you get to recover for losses you didn't incur. The way it reads is, and this is what really gets me to the bottom

of the page is what's missing from their description of the only issue in the case is reasonable and in good faith calculate what its total losses and costs. It's right there in the definition of loss. It's not just your running a reasonable process and a good faith process, but to do what? To calculate your total losses and costs.

The end result of that process was a valuation that triples the value of the transactions from either the 9/12 collateral valuation or the 9/15 marks the used to call collateral from us. The tripling of the value, is that a reasonable result here given, albeit, everything going on in the market, what decisions they made; what points in time they pick; what charges they added on; is that a reasonable result? And does the totality of the evidence demonstrate good faith? Now, we can have an extended discussion about what is and isn't good faith. We're not suggesting that there's bad people on the other side. I would suggest to you that you were cited a series of U.K. cases on reasonableness and good faith and I do believe on the question of good faith and reasonableness, the articulation of what that is under English law is quite different than what it is under New York law.

That's going to be a legal question to decide as to whether the standard of the evidence, the acts you hear about, the analysis or lack thereof that you find in the

record, whether that supports ultimately a conclusion that there was an absence of good faith, but that's going to have to be -- I think the good faith calculation -- determination is on the basis of the totality of the evidence. And how much of what you're going to hear is really what QVT knew and did at the time? As we went through the specific calculations, the specific buckets this morning and early afternoon, PCDS, COG , detailed analyses of what was going on, on market and what different ratios were and what spread were, you're not going to find that in the contemporary analysis that was done by QVT. What's striking is the lack of analysis. I get the point. They're all sitting around a couple of desks, so they're not shooting emails to each other, but these products are so complex and illiquid, where are the models? Where are the screenshots? There was a mailbox they setup, Lehman@QVT to collect backup. Where is the analysis that says, made an effort to be reasonable about their approach as opposed to maximizing, their approach to this calculation?

Ultimately, notwithstanding all of the post-talk justifications for doing what they did, what we think has happened here, you get to 9/15, they make the decision to terminate on 9/15. They didn't have to terminate on 9/15. Okay, they had the option and we'll talk about that briefly -- there's nothing in the ISDA Master Agreement that says,

if you're outside of automatic early termination, as the non-faulting party, you absolutely have to deliver your terminations. They have the right to. We're not saying they didn't have the right to deliver that notice.

But once they did that, that had an important consequence. Those Lehman positions, if they had stayed alive, everything I've seen from their side, would have become more valuable because they were long protection and credit spreads widened on Tuesday, Wednesday, Thursday. They realized once they had terminated those straights, as a legal matter, they no longer had a right to enjoy those gains. But that was -- that result, the fact that they don't get to enjoy those gains that happened after the termination, that's because of the choice they made. They terminated that.

The contract would have fully protected them if they had not terminated half the trades alive. They terminated on Friday. And there's a trade-off there, right. They wanted certainty on Monday. They wanted the certainty of saying, "We're done. We have no more open Lehman positions." That's fine, but it comes at a price. It comes up to several prices, right. The obligations get kicked in as to what you have to now do. Now, that you've delivered the notice, things have to begin to happen. The market quotation process has to be run. Markets are going to move

from here on out. You don't have the right to seek recovery on the basis of those market moves and I think what the record will show is that, that is exactly what they were trying to recover. That's what Dan Gold's email to investors on September 23 was about. Spreads had widened, markets had moved. There were profits they could have made if they had their trades on with Lehman; they didn't make those profits that we are going to try and recover those profits as well.

That's why you have valuations on the 16th, the 17th -- that's why you have these new indented methodologies for valuing PCDS and CARB . You asked a couple of questions about, well, these are derivatives -- they derive their prices by definition from some underline. Did you go look at how the underlines moved? It's not what they did. They had the underline for PCDS. They had the underlined preferred data, but they came up with a formula that they didn't back test and had they back tested would have shown that it's nonsensical and we'll get into it.

So what's driving QVT after 9/15 is really this notion of what could have been. We could have had these returns if we hadn't terminated. The world's going to hell in a hand basket, bad things are happening. We're going to include all of these losses in our claim against Lehman, but the contract doesn't permit them to do that. It's got to be

their total losses and costs.  Can't be what might have happened, some imaginary number.  What did you lose?  What did this really cost you and what did you cost you as of the early termination date.

The definition of loss is very clear.  It's as of the early termination date or as soon thereafter as reasonably practical, right.  But this entire exercise was a backward look into the business.  This wasn't a calculation they had to do on the evening of the 15th or the morning of the 16th.  They did it two weekends later.  We talk about their books and records, there's no evidence of actual losses or costs incurred by QVT of this magnitude.  It's just not reflected on their books and records.  There's one place it's reflected.  It's reflected in the calculation statement.  It's reflected in the statement of claim.  If you go through their accounting records, you don't see evidence of that kind of a hit, a $260 million hit over and above the collateral they have.

We think the approach here, which is to do this backward looking exercise; to try and create these hypothetical replacement trades, not on the early termination date, but on dates after the early termination date to seek to recover (indiscernible ) spreads for transactions that you did not replace and chose not to replace because they certainly replaced a good number.  All

of that exposes Lehman and its creditors the moral hazard because that's a one-way exercise. They just get to say, "Well, we might have replaced them. Had we replaced some, some dealer might have charged us an astronomical sum." You're not going to hear evidence from their side as to what dealer was going to charge that and what transaction would actually happen on those charts. And we'll talk about PCDS in particular because the transactions that they have now constructed -- the hypothetical transaction is one that would never be done.

This is not the only instance where you have encountered, Your Honor, illiquid transactions. Lehman had what, 6,500 counterparties. They had a derivative on everything under the sun. There were things that were liquid; there were things that were illiquid. There were products like, reserve funding agreements, 30-year long-term contracts that just disappeared from the market. That doesn't mean that you can just tack on an astronomical number to that and say, that's my loss. There has to be some determination made of what did you reasonable lose? What is the loss of bargain that you're complaining about? Loss does have that phrase, loss of bargain. What was your bargain? We can't talk about that in terms of what the contract provides and what loss of bargain means versus what they would have you think.

Burden of proof -- I don't think it's seriously disputed that they have the burden of proof. I know there was a case cited -- our case is completely inapposite because you're talking about a claim being brought for breach of covenant of good faith and fair dealing upon bringing a claim for breach of the covenant of good faith and fair dealing in most instances, I'd probably have the burden of proof on that. Here, the contract requires them to act in good faith and reasonably, they're making a claim against the estate. They have the burden of proof. That's precisely why they went first with their expert reports. That's why they went first this morning. That's why they're going to have a rebuttal case. They have the burden of proof and they know it.

I do think they have to demonstrate with respect to each transaction that they acted reasonably in good faith because they did it on a transaction-by-transaction basis. And they used different methodologies for different transactions. It wasn't just one size fits all. And I think they have to convince you that they've met their burden of proof with respect to all the (indiscernible ). Not just those that have been challenged by Lehman's experts. They have to make the showing. They, in fact, have a basis for a claim for every dollar they're seeking from the estate. And they have to tie that to their total

losses and costs. We don't think they can meet the burden of proof. They chose 9/15, they elected 9/15 and we're bucketing the arguments and the arguments will cut across different products. Fundamentally, our points are four, right. They ignored the historical books and records; they cherry picked post-9/15-08 market data and let's just pause on cherry picked. We'll come back to this. The fact that valued their transactions after 9/15 increased their claim. Could they have increased their claim even more? Maybe. But I'll submit to you for every --

THE COURT: The fact that they -- when you say after --

MR. TAMBE: Yep.

THE COURT: -- you mean --

MR. TAMBE: Using --

THE COURT: -- as of a date after?

MR. TAMBE: Yep.

THE COURT: Because the whole exercise was after?

MR. TAMBE: That's right, yep. The use of new and untested valuation methodologies, again, we think they can't sustain their burden that those were reasonable. And instead what you have is a lot of post-talk arguments about justifications for why they did what they did, which don't particularly work and are often rendered by experts that have no expertise in the markets or the products that we're

talking about.

We heard at length about Professor Engle. Well, if the attacks coming from Professor Pfleiderer, who is a great professor of finance and economics at Stanford, he has really no basis or expertise to comment on the valuation of credit during this process. That's not part of his academic work. It's not part of his experience. He doesn't do any analysis. I mentioned before, it's sort of equivalent to sprinkling holy water on what QVT did and saying, "It looks reasonable to me."

So, the things that are not challenging, they should still prove up the facts, but we're not challenging the 12 trades where market quotations were received, albeit, the (indiscernible ) flawed process. We're not challenging QVT's total losses and costs in connection with (indiscernible ). They demonstrated that they actually incurred those costs and entered into those trades and they have entered into some of those trades after 9/15. We're not challenging that. And there's a reason for that. At the bottom of all of this, why are we here after so many years of litigation, right. The professionals of the estate are fiduciaries to the creditors. They have to ensure that all claims are resolved fairly and equitably and that's what this trial's about. And for the most part we’ve been able to achieve all of that, without trials. Sometimes we can,

and we have trials over it. I have a series of legal provisions here, I'm not going to go through those. I might come back to them as we discuss other points. So I'm going to switch forward to slide 14.

THE COURT: Okay.

MR. TAMBE: Nothing earth-shattering here. This is the sequence of events. But to suggest that this was not a new trading relationship -- this trading relationship's over a long period of time. And what's significant is, even after the (indiscernible ) were put on, you know, '06, '07, '08, you don't have any material disputes between Lehman and QBT about the evaluation even -- and you saw all these slides from them -- starting in 2007 and into 2008, there's a general recognition, a lack of liquidity (indiscernible ) and you don't see a dispute, a demand for additional collateral, additional security from QBT. And all the while, by the way, the credit markets and credit spreads are worsening, certainly as we get into 2008. That process accelerates and Lehman (indiscernible ). And let's not forget that as those credit markets changed, Lehman was posting collateral, and those calculations were being looked at both by QBT and by Lehman. And they held on $17 million of collateral as of 9/15.

You'll hear evidence in the case about the fact that they were focused on the margin position. This wasn't

a calculation just running in the background where no one paid any attention. I think Mr. Tracey said -- Mr. Gold and his -- and his colleagues are (indiscernible ) for the investors. They have an obligation to get it right (indiscernible ) they thought they were getting it right. And they tried to get it right. And they then just accept Lehman’s marks, they examine Lehman’s marks, and there were times when they questioned Lehman’s marks. But what’s significant is, they never said, hey, you’re getting it really wrong. You’re not looking at the price of (indiscernible ) properly. It’s gone completely a liquid, credit spreads are rising, your evaluation methodology doesn’t work. Or, here’s your card mark, we think it’s way out of line. You should change it and post more collateral. There’s no such communication between the parties. Significant because all of a sudden you have after 9/15 the suggestion that the marks were off by $250 million. Some of that can be explained by the movement from the 12th to the 15th, but not that magnitude.

I’m going to go to one more slide, slide 12. We are not collateral is the measure of loss. (Indiscernible ) right, that’s not our position. Is it relevant? Yes, it is relevant, and it’s relevant because of what it purports to be and is supposed to be. It’s supposed to be this definition of exposure from the (indiscernible ) the amount

that would be payable, right, to a party that is a secured party by the other party, pursuant to Section 6C-2a of this agreement as if all transactions are swapped. Transactions were being terminated as of the relevant evaluation time, and it goes on to say its market quotation is going to be determined at mid-market. So clearly what we're trying to calculate here is not just some amount that'll make you feel secure, but it's an amount that will be paid if all transactions were being terminated. There's a connection made to the termination of the transaction. And the next part, all calculations done by either party are supposed to be done in good faith (indiscernible ) which brings us to the September 16th collateral.

THE COURT: So go back for a second --

MR. TAMBE: Yes, sure.

THE COURT: -- Mr. Tambe. So focusing on the wording of the definition of exposure --

MR. TAMBE: Yep.

THE COURT: -- you had said before you got here that you're not saying that the amount of collateral is equal to evaluation.

MR. TAMBE: Yes.

THE COURT: Right? But isn't that what the definition of exposure says? It says --

MR. TAMBE: It does, but the calc -- but here's

the thing; as of the relevant evaluation time. Right, and so if you look at a collateral call that was made, for example, (indiscernible )

THE COURT: Evaluation time refers to the time the collateral --

MR. TAMBE: Evaluation of the collateral call, right.

THE COURT: Right.

MR. TAMBE: So we recognize that they could be a slippage or a movement, and that's why the September 16 collateral call is important, because they call collateral from us --

THE COURT: So evaluation time and early termination date are not the same thing?

MR. TAMBE: They're not the same thing.

THE COURT: Right.

MR. TAMBE: But --

THE COURT: Okay.

MR. TAMBE: -- again, how far apart are they?

THE COURT: Yep.

MR. TAMBE: And how much should that drive the difference? I mean, that's a relevant inquiry, and they say --

THE COURT: Right.

MR. TAMBE: -- it's entirely irrelevant. We're

not saying it’s determinative. We think it’s highly relevant, right, especially because of the processes that parties have followed for a very long time, and then all of a sudden you get to a point when you’re no longer following those processes and doing something completely different. I think The Court should consider, is that a reasonable departure from the way things were done? And the bottom, right, they’ll say, well, Lehman was the evaluation agent. But when QBT’s asking for collateral, which they did on the 16th -- they set -- sent us $13 million. That’s a demand made out of the CSA. That’s the way they appraised it. Or maybe they’re hoping to get lucky if someone wasn’t paying attention at a company that was in chaos and would simply wire $13.3 million over. But they did a calculation internally. It’s a calculation that ties out to the values on their books on 9/15, not 9/12, not 9/11, on 9/15. They did the math, they went out to Lehman, Lehman said, we’re not going to honor any calls today. And that email chain was circulated high management at QBT. (Indiscernible ) said, oh, what are we doing asking collateral? Those numbers don’t make any sense. No one said that. What are you doing asking for a collateral call, you're not authorized to ask for a collateral call? We've heard those stories by the way. No one said that. This was intended. They wanted to use their calculation to extract collateral

back from Lehman and the contract said, "That was a good faith and commercially reasonable calculation." That's what it was supposed to be. That's what it had to be.

Let's go to 18. That's the email that was sent. Utterly routine to Lehman, I see there's an end-to-end movement from end of business from 98/12 to 9/15, plus $12 million in QVT and $1.3 million in Quintessence, are you able to meet this call? And you'll hear testimony from their witnesses about exactly how that amount was calculated -- calculated by using their 9/15 facts. So where is the $260 million loss? Not there. Not in their books and records.

So let's get to the valuation. I'm sorry, I'm going back and forth a little bit --

THE COURT: Mm hmm.

MR. TAMBE: -- I'm just adjusting to a couple of things that were said. This is one worth looking at. So, this is the Sunday before and this goes to a point that I discussed in my first few minutes, that they were focused on margin and exposure to Lehman. This is a spreadsheet that gets distributed again, within the folks in QVT from Julian Sale internal to QVT. From what that's reporting is, the value of the Lehman position, not as of 9/11, but as of 9/12 -- close of business 9/12 and the margin they hold, right. And even as of Sunday evening, right, they are over-

collateralized. So you've heard a lot about all the chaos and how the markets could only move in one direction, well their unlocks were showing from Thursday to Friday, the positions that actually moved in Lehman's favor. They were over-collateralized. They were holding too much collateral. And this goes to the other point, they knew what the LBS acquisitions were ELBS were. This isn't a mystery as to what trades we have on. We've got to value to the last dollar. And I would say unlike a lot of other counterparties, we are thinking about the potential of the Lehman default and preparing for a potential Lehman default well before 9/15. I know the timeline you saw about the market quotation process began on 9/15 in the morning, but the fact of the matter is folks within QVT were discussing market quotation and the need for actionable quotes days before.

Now, slide 20, Your Honor. Do you have any questions about that?

THE COURT: Nope. Good.

MR. TAMBE: Go to 20. So this gets to the point and it was raised by Mr. Tracey, performing poorly. True Lehman bankruptcy performed poorly after Lehman bankruptcy. Again, you would think that if these positions were more valuable and they were more in the money, surprising to me that they wouldn't say, these things are more valuable,

we're actually doing a little bit better than you investors think we are. There are actually really valuable positions we have on the (indiscernible ). They don't say that while Lehman's alive. Once Lehman is dead, yeah, these are incredibly valuable positions. They're worth another $260 million, but they only say that in the statement of claims, not on their books and records.

So they take -- they try to take steps, prior to Lehman bankruptcy. They tried to (indiscernible ) trades to other dealers. They tried to move positions that were held at LBI or LBIE to other prime brokers. None of this has anything to do with LBSF, but again, it shows a level of preparedness and focus on the Lehman situation. They also bought protection should Lehman failure. So SDS on Lehman. They're not part of the claim, but again, in terms of telling the story, these are folks who are preparing, who are valuing, who are considering their positions. this notion that 9/15 rolls along and they have no idea how to value these claims, I think strains (indiscernible ) to some extent.

THE COURT: What do you mean they bought protect -- they bought CDS on Lehman?

MR. TAMBE: Yeah. They thought Lehman would fail. They thought many other financial institutions might fail --

THE COURT: Right.

MR. TAMBE: -- and they want protection.

THE COURT: When did they buy the protection on Lehman?

MR. TAMBE: I don't know the answer to that. They also -- there was an exercise over the weekend where they identified positions to be replaced, right. So again, this is preparedness and I would submit, a very high level of preparedness. Again, it puts in context this notion or this compressed timeline on the 15th and why we're trying to figure what we should do. This is a counterparty that's been doing some thinking and doing some preparing. And I'm not going to minimize the impact of the filing and the fact that a lot of people were scrambling as a result of that. But they still continue and there's different levels of sophistication and I would submit to Your Honor, they fall at one end of that spectrum. They're highly sophisticated, they're highly prepared.

THE COURT: So does that mean I should hold them to a higher standard?

MR. TAMBE: I think in judging the reasonableness in good faith of their action, you should judge it against their sophistication, not the sophistication, for example, of some school district in Ohio. So they identified positions to be replaced, urgent, not urgent, et cetera. They started replacing transactions I think as early as 5:00

a.m. on 9/15.

THE COURT: So Lehman filed at 1:10 a.m. --

MR. TAMBE: Mm hmm.

THE COURT: -- on 9/15?

MR. TAMBE: Yep. And I don't think the notice of early termination went out until later in the morning, so they were effectively replacing transactions starting Monday morning. Even before the market quotation script is prepared, before the market quotation ones go out, they are replacing the trades they wish to replace and they focused on collateral.

THE COURT: They replaced trades before they were actually terminated?

MR. TAMBE: I believe that's the sequence. At least some trades were replaced before, in anticipation off the fact that there would be a termination. They probably thought -- they prioritized the collateral issue and that's what leads to the 9/16 collateral call where they're trying to get the money back from them. So this is the 9/23 email to investors from Mr. Gold. So let's do a couple of things. Actually, could you pull up the document? It's EX-5466-5466. In the top part -- let's just see the top part increased in size. And let's just start with the -- just the two-prong subject line in the first two paragraphs, down to -- next -- yeah, right down there. Perfect. Couple

points here, right, it goes out on the 23rd 9:00 in the evening. We only mark our books at the end of the month. That's when we tell investors what their performance is. This is the 23rd of September. There were emails with intra-month performance the weekend before Lehman failed. So this notion that, well, we don't generally mark our books during the month, we do it at the end of the month and then we report to investors what the performance of the funds is, not true, Judge. They're keeping investors apprised of how the funds are doing on an intra-month basis. Tey're looking at some data. They're looking at some evaluation. 9/23/2008 they're providing return stats as of 9/23, all right. Let's go further down into the document, the section that begins, "The Lehman Brothers," which I think is at the end of -- shall I hold on, maybe under page 2. Yep, that paragraph, the whole Lehman Brothers paragraph. And the first paragraph there, though. Now, they're talking about the process, so termination on 9/15. There are values on their books at 9/15. They're reporting performance to investors on 9/23, but they're constructing the claim. The first weekend of claim construction is gone; that was the first week in the 20th, 21st. A lot of the claim construction happens the following weekend, which is the 27th, 28th, right. They say it's very time-consuming and we had not yet finalized the claims, and it's the second line:

lost profit opportunities. We highlight that whole -- the rest of it. And that's the sentence, Judge. Lost profit opportunities may also count as damages. That is, it is possible to be damaged even if one doesn't actually lose money if one would have made money, but for the counterparty's default. And what they're talking about there is the money they would have made had they not terminated Lehman at 9/15 because those positions would have gone up in value. That's what they're trying to recover. They make another statement to that effect and they're going to say, no, that's not what we're talking about. It's just replacement risk, replacement value. Then annual reports that went out at the end of that year, and that's Exhibit 5254 (indiscernible ) page 15 ones. It's not in the deck here.

THE COURT: Okay.

MR. TAMBE: And we'll go to the bottom. It's going to be the very -- yeah. So if you can just expand that paragraph, "Exposure to Lehman Brothers." That paragraph -- and if you could highlight at the beginning, five from the bottom, would even in the right-hand side. Yeah, all the way down from there. They're talking about two different concepts here, okay. They see even though at the time of Lehman's failure, the fund held collateral from Lehman in amounts close to the positive mark to market value

of derivative positions valued as of the business date preceding Lehman's filing for bankruptcy less required initial margin. The fund did not have sufficient collateral to cover the replacement costs and mark to market gains in respect of such derivative positions resulting from their rapid increase in value following Lehman's failure. Replacement costs were not challenging. We're saying, okay, if you incurred actual replacement costs, you get it. It's this mark to market gains in respect of such derivative's positions resulting from their rapid increase in value following Lehman's failure. And you'll see the prices they use on 9/16, 9/17, 9/18, 9/19, this is in worsening credit market. Those are the gains that they're referring to here. Those are the gains these positions would have been enjoyed, but they don't get the benefit of those gains because they chose to terminate on 9/15. But that -- on 9/23, we believe, the message was quite clear -- the markets have moved substantially after Lehman's termination, Lehman's default. We terminated on the date of Lehman's default. There are profits we could have earned on those positions; we're going to recover them through the loss calculation. And that's what the loss calculation shows on its face. They choose dates after 9/15 because that's what they're trying to recover, and that's not compensable measure of loss under the loss definition.

THE COURT: Can I ask a --

MR. TAMBE: Mm hmm.

THE COURT: -- question about -- and if it's not something that's really going to be developed, just tell me.

MR. TAMBE: Mm hmm.

THE COURT: Back on your slide 21 --

MR. TAMBE: Mm hmm.

THE COURT: -- in the highlighted paragraph, second paragraph, because of the -- of certain -- because other certain of our portfolio level hedges including but not limited to CDS on Lehman...

MR. TAMBE: Mm hmm.

THE COURT: Is it your contention that because they separately hedged their Lehman exposure -- they separately hedged to some extent Lehman's failure --

MR. TAMBE: Mm hmm.

THE COURT: -- that they ought not -- that, that's an offset, if you will. Or it's almost like a recovery on a guarantee that would be available as a set off to what their loss was? Or is that just a separate thing; that was a separate bet that they placed and that's got nothing to do with the amount of their "loss" that they incurred.

MR. TAMBE: I'll say it was a separate bet. And -- right. And I don't think it has anything to do with their loss calculation. I think, the way you stated it, it has

nothing at all to do -- I don't think it does. We're not arguing that, because they may have gone to Deutsche Bank and bought protection on Lehman --

THE COURT: Right. Right.

MR. TAMBE: And that contract paid out --

THE COURT: Separate bet.

MR. TAMBE: Separate bet.

THE COURT: Okay.

MR. TAMBE: So, now we're going to go through, I think, the different categories of where we --

THE COURT: So, but --

MR. TAMBE: Yeah?

THE COURT: Just -- I'd just like to match up. So, the narrative that QVT started with was that this whole -- you rode -- QVT rode the market up, is false. And there was, at one point in the presentation, a pie chart that shows, "Oh, look, we actually took positions, two -- almost two-thirds of the positions valuations that we took were the most favorable to Lehman." And -- you know which one I'm talking about?

MR. TAMBE: No, I'm laughing. I'm smiling. I'll tell you why I'm smiling. Have you read Danny Kahneman's book?

THE COURT: Who?

MR. TAMBE: "Thinking Quick"? "By Thinking Fast,

Thinking Slow," right? So, Michael Lewis -- Michael Lewis?

THE COURT: Yes, I know who Michael Lewis is.

MR. TAMBE: Right. He's got a new bestseller out.

THE COURT: Yes, he does.

MR. TAMBE: Okay.

THE COURT: I have --

MR. TAMBE: That bestseller is about Danny Kahneman.

THE COURT: I haven't read it yet.

MR. TAMBE: Okay.

THE COURT: Okay.

MR. TAMBE: So, what Danny Kahneman is talking about is what people get wrong with statistics. And he's got a whole -- he did a -- he won a Nobel Prize, eventually, right? And people get stuff wrong with statistics all the time, and it depends on the question you're asked.

THE COURT: Sure.

MR. TAMBE: Your recollection of that chart isn't what the chart really shows. And what the chart shows isn't really what they mean to say. So, let's go to the chart.

THE COURT: Okay.

MR. TAMBE: So, if you go to 101 (indiscernible), we have a problem with the deck.

THE COURT: We have that discrepancy, right.

MR. TAMBE: But I'm looking at the printed deck,

and the data was in 101, and the pie chart --

THE COURT: On the printed deck, it's -- the pie chart is in 102.

MR. TAMBE: Yeah, the pie chart is in 102, right?

THE COURT: Right.

MR. TAMBE: So, I think what's driving that -- I'm not sure, but I think what's driving that chart is what we see on the previous page in the data. And they've changed the question from "more favorable to QVT" to "most favorable to QVT." Right? And they're saying: was -- were these prices most favorable to QVT? Were they most favorable to Lehman? And that part is put together with, "it's not most favorable to either Lehman or QVT."

THE COURT: Uh huh.

MR. TAMBE: The question asked makes a difference. Were the prices more favorable to QVT? Let's go back to 101.

THE COURT: Okay.

MR. TAMBE: Starting from the bottom, 268 as of the 16th, more favorable than 250. 568, more favorable than 534. 550, more favorable than 320. 538, not more favorable than 564. Right? And seven, I don't know if you've got positives or negatives, but you have a seven that's picked versus 35 (indiscernible). So, you assume those two -- I don't know which way their figures run, but now you've kind

of flipped the answer. Now it's 60 percent, three of the five trades, are more favorable to QVT if I'm valuing them after 9/15.

So, you go back to the chart, and go back to Michael Lewis's book and Danny Kahneman's work. Right? The answer you're going to get to these kinds of statistical analyses is going to be very different depending on what question is asked. And the fact of the matter is most people, you and I included, and a lot of experts included, get that wrong. It's astonishing how much people get that wrong.

Right? We have this extended discussion of Professor Engle and what he got wrong. Professor Engle will tell you why what he -- what he did and why he did what he did. Right? And you can do all these pie charts and reduce stuff down. But let's get back to the question that's really being asked and what's the question that's being answered.

At the end of the day, Professor Engle doesn't value QVT's trades. A trader with experience valuing trades takes some of Professor Engle's output and says, "You know what? That's consistent with what I saw in the market when I was trading. It confirms my recollection being in the markets at that time, and I'm going to do the calculation, because I have that trader judgment and trader expertise,"

and that's Mr. Garcia.

You didn't hear about Mr. Garcia very much when we were going after Professor Engle for all the things that he didn't do. He's got a Nobel Prize; I think he could defend himself and the validity of his work, and what conclusions can and cannot be drawn from his work. He'll be the first to tell you what conclusions shouldn't be drawn from his work. Hmm? All right.

But you got to read the Kahneman book, because -- I hate to say it, because we do a number of --

THE COURT: In my spare time, Mr. Tambe.

(LAUGHTER IN THE COURTROOM)

MR. TAMBE: I'll belabor this, but only a little. We're going to see some more examples of this, because we deal with numbers a lot, right? And we deal with complexity a lot. And you hear about the complexity of these products, the fog of Lehman. Isn't it obvious that everything would have gone down? And you get this confirmation bias, yeah. It was terrible. Everything was falling apart. It must have been.

And then you look at the data. And the data doesn't always follow that. Right? And we'll come back to that theme a little bit.

THE COURT: Okay. But, again?

MR. TAMBE: Yeah?

THE COURT: It's what was reasonable --

MR. TAMBE: Yes.

THE COURT: At the time, not perfect, or best even, in retrospect.

MR. TAMBE: I'm not suggesting -- and was the process reasonable?

THE COURT: Right.

MR. TAMBE: Or was it, in effect, an arbitrary process, which was taken on without doing any testing to say, "Hey, we've adopted a new process. Does this make any sense?"

THE COURT: Right.

MR. TAMBE: "Does it hold true?"

THE COURT: Right. Okay. So, we're back to your book.

MR. TAMBE: We're back to our book. Okay. So, we go -- we'll go into market quotation. I won't dwell on that a lot; I think we've said -- we've laid at least the groundwork for what we will be trying to show on market quotation. Yeah?

THE COURT: So, on market quotation, are you going to be trying to show, essentially, that, well, QVT says, "We put it out; it was late in the day, but everybody knew that they could still continue to respond into the 16th; look, a bunch of people did"?

But you seem to be suggesting that it was to the contrary, that they put it out late, they knew that people wouldn't respond, they knew that, even though they might have thought that they would get a more robust set of quotations on the 16th, they purposely just, you know, did it when they did it on the 15th, knowing -- essentially, knowing that it was designed to fail.

MR. TAMBE: So, there are two or three threads in there.

THE COURT: Sure.

MR. TAMBE: Right? Including this notion of you're hearing an explanation, in the course of this litigation, which is belied by what happened then and what QVT believed then. So, let me start there, and hopefully I'll address the rest of your questions while I'm answering this. I might lose track of one.

THE COURT: Do you need some water, Mr. Tambe?

MR. TAMBE: I don't think that's going to help the frog, but. That's all right. As long as you can understand me --

THE COURT: I can.

MR. TAMBE: And I'm not talking too fast, we'll be fine. So, let's start with Slide 26. Thank you.

THE COURT: Okay.

MR. TAMBE: Right. So, this is the back-and-forth

at the time the contract was negotiated. Clearly, when they believed that they were likely to be the defaulting party, they wanted Lehman to have less discretion. They wanted market quotation. And the reason they gave for market quotation, they said, "Look, most of our positions have already market with easily obtained quotations." And that's all fine. We get it.

They do other -- ISDA master agreement in '07 for a quintessence, when that split happens.

THE COURT: Right.

MR. TAMBE: And again they pick market quotation. At least some of these products are trading then; they are still comfortable sticking with market quotation.

And, during the process of calculating collateral -- right, so we go back to the discussion we had about, "What does exposure mean?" If, after '05 and after '07, QVT had concluded, "Hey, we've got market quotation in our ISDA, but we're not picking up these positions -- BCDS, CAR -- that seem to be fairly illiquid. We should revisit this. We should revisit this with Lehman and say, 'Guys, we don't think market quotation is going to work for these.'"

That didn't happen, right? It's the contrary. They took the prices from Lehman; they looked at them; they analyzed them; they reflected them in their books and records; they showed them to their auditors. They didn't

just swallow those prices and say, "Well, if Lehman says it, it must be good."

And they had the tools to do the valuation. I mean, this is not, again, an Ohio school district. This is 9, 10, $11 billion fund, with fiduciary duties to its investors, with data feeds from all the great data sources and some of the smartest folks who came out of Boston. So, they certainly had the wherewithal and the incentive. And, if that wasn't enough, they had the obligation to get it right.

All right. So, they wanted market quotation, Slide 27. This is September 8th, September 11th, before the bankruptcy. And we'll talk about more of these email chains. But the point of this email chain is: here they are, talking about market quotation and how market quotation is supposed to work. And this is in anticipation of Lehman. What if Lehman fails, one of our big swap counterparties? Right? What do we have to do?

Very early on, they knew that they had to seek actionable quotations. It's not something they're scrambling to find out on the morning of the 15th. Let's go back to the timeline. This timeline should really start back on --

THE COURT: What's this? You got to help me with this terminology.

MR. TAMBE: Yeah.

THE COURT: So, Metter to Chu on the 8th.

MR. TAMBE: Yeah.

THE COURT: What does it mean, "lift the dealers"?

MR. TAMBE: Actually do the deal. So, you get a quote back; do you have to hit it? You have to say, "Done. I want to do that deal." Right? And we're not suggesting you have to respond to a market quotation and hit the deal. But the quotation should be actionable; that we do agree with. We would say, as a -- and Lehman's taken this position consistently -- the quotation should be actionable. And that's how they understood the market quotation process to work.

THE COURT: Okay.

MR. TAMBE: That it was seeking actionable quotes, which calls into question this whole, more recent discussion about, "Well, 'as off' could be -- you could get it later." Well, if you could get it later, it wasn't going to be actionable, because the time has passed. If it's going to be actionable, you do it then and there. And there's more to that, right? So -- yeah?

THE COURT: But you -- I mean, there is a chicken-and-egg problem, because you can't ask as of a time that hasn't occurred. And then, the minute the as-of time occurs, it's -- I mean, you could -- you then -- you're not

going to have an auction for this security before they quote the price, right?

MR. TAMBE: Sure. Yeah.

THE COURT: They're going to quote the price. And then, if they wanted to transact, they would get on the phone and --

MR. TAMBE: That's right.

THE COURT: Right?

MR. TAMBE: And that's the -- and that happens in real time. That doesn't happen over periods of hours.

THE COURT: That's right.

MR. TAMBE: When you're actually doing actionable -- an actionable exercise, you're setting it up so that they come back in competition. And one of the things you saw -- and maybe it wasn't pointed out to you -- in the -- the quote emails that went out had all that language from ISDA.

But the cover of those emails said, "BWIC, OWIC," right? And -- "Bids wanted in competition, offers wanted in competition." That's not in the ISDA itself. But that has meaning. To be in competition, you got to be in the competition. You can't come in four hours later and say, "Hey, I want to be in."

THE COURT: So --

MR. TAMBE: There was another signal they were sending that 4:00 was the deadline. And that's how they

understood it, and that's how dealers understood it. So, let's talk about both of those, and we'll come back to this.

I should answer your questions before moving on.

THE COURT: No, I understand.

MR. TAMBE: Okay.

THE COURT: You have answered my question.

MR. TAMBE: Okay. So, 30, let's just talk about 30 for a second. Right? So, on the left-hand side, that's -- why don't we pull that up, 5147? It's...

And just increase the (indiscernible). Okay. So, that's from Tom Knox of QVT, sending out the "BWIC, OWIC." "We would appreciate your responses by 4 p.m. today."

THE COURT: Okay. So, this is an emerging market CDS?

MR. TAMBE: Yeah.

THE COURT: Okay.

MR. TAMBE: Yeah? So, clearly, the text of that -- the attachment, right, reads exactly like all the other attachments. But Mr. Knox believes, "Hey, got to have your responses by 4 p.m. today." That's how Tom Knox at QVT understood that.

Let's look at 31, and that's Joint Exhibit 61. Why don't we just pull that up, and then look at the actual documents? If that's 61, just increase the --

This is Joel Wollman at QVT to someone at BarCap.

They're the guys who got it late, right? "It was originally for 4 p.m. But, since you didn't get it, if you could get back to us by 4:30-4:45, that would be good." QVT knew what they wanted. They wanted the quotes back by 4 p.m. That's how they understood the request they'd sent out. They wanted bids in competition and offers in competition.

So, there's a lot of talk about what dealers may have inferred. I don't know what dealers they're talking about; I'm not sure what evidence you're going to hear from dealers saying, "Hey, we got this from QVT and we thought they meant mañana." Right? In fact, the evidence that's in the record -- let's go to 5149, the bottom.

Citi gets the request. And Citi says, internally, "Due at 4 p.m."

THE COURT: I'm losing the two (indiscernible).

MR. TAMBE: Okay.

THE COURT: So --

MR. TAMBE: So, we'll have to pull up the whole document, and let's --

THE COURT: So, Wollman to (indiscernible)?

MR. TAMBE: No. We're not going to go there. Let's start with the email chain from the bottom and move up. Yeah.

THE COURT: Right. So, it's Wollman to... right. So, what's the Lehman to QVT.com? Isn't that their --

that's internal?

MR. TAMBE: So, that's the -- that's where he's keeping it internally, right?

THE COURT: Right, that's internal. And then it goes --

MR. TAMBE: So, if you follow the email chain up?

THE COURT: Right.

MR. TAMBE: Here. So, it's sent to Lehman@QVT.com. It's BCCed out to the dealers.

THE COURT: To the traders.

MR. TAMBE: Right.

THE COURT: So, they don't know who's -- who they're asking.

MR. TAMBE: Right. Right.

THE COURT: Right.

MR. TAMBE: And so, if you go to the bottom of this page, you'll see who's saying, "Due at 4 p.m." It's this guy Syed Haider, right? And it says there, "CMB FICC."

THE COURT: Okay. But who --

MR. TAMBE: That's a trader at Citi.

THE COURT: That's a trader at Citi.

MR. TAMBE: Citi, yeah.

THE COURT: Okay.

MR. TAMBE: That's within Citi. And you'll see that email chain gets forwarded up. You'll see, at the next

signature block up -- there you go.

THE COURT: I'm sorry, go back down. Who writes, "Due at 4 p.m."?

MR. TAMBE: Internal, Citi to Citi. This is within Citi.

THE COURT: Within Citi?

MR. TAMBE: Yeah.

THE COURT: Okay.

MR. TAMBE: And the point I was making is you heard a lot about how dealers would have viewed this request from QVT.

THE COURT: I see.

MR. TAMBE: And you were told, "Well, dealers getting this would realize it's as-off. They're not going to be confused by it." No, they thought it was due at 4 p.m. just like Mr. Knox did, just like Mr. Wollman did. They all believed 4 p.m. was the deadline, because they had said, "BWIC, OWIC," because they were looking for actionable quotes.

And if we go up on this email chain, and just highlight the top two, please? The top two -- yeah, that's it, all the way down. I want to pick up the signature block. That's it.

And this is at 3:30. So, you're getting email traffic at 3:30 from someone at Citi. You see the Citi

address.

THE COURT: Right.

MR. TAMBE: Right? To Joel Wollman -- to Haider, and Joel Wollman is CCed. And then Joel responds and says, "I'm asking you to offer me a positive IO," I believe is what it says.

THE COURT: IO is an indicative offer, or no?

MR. TAMBE: It's what?

THE COURT: What's IO?

MR. TAMBE: I don't know what IO is. We'll find out from Mr. Wollman, right? The point of this email is Mr. Wollman sees in this email chain, "They're saying due at 4 p.m." We know from the --

THE COURT: But, when he says, "Which way are you going on your IOs," isn't he asking who's in the money, who's -- I mean, what -- I don't know what I'm looking at.

MR. TRACEY: It's interest-only.

MR. TAMBE: Interest-only.

THE COURT: Interest-only.

MR. TRACEY: Interest-only.

THE COURT: So, clean versus dirty price, got it. Okay.

MR. TAMBE: I'm not sure it's clean versus dirty.

MR. TRACEY: No, it's not that.

THE COURT: No?

MR. TAMBE: It's not that.

MR. TRACEY: It's interest-only; it's different from a bid and different from an offer. It's an interest-only.

THE COURT: Okay.

MR. TAMBE: I'm not -- okay, now he -- now Mr. Tracey is up.

THE COURT: Now he's (indiscernible)?

MR. TAMBE: We'll get evidence from a witness who will tell us what that meant.

THE COURT: Sounds good.

MR. TAMBE: The point of this email, however, is not whether it's IO or not. It's Citi believed this to be due at 4 p.m. That's the point of this email.

THE COURT: Okay.

MR. TAMBE: Right? And Mr. Wollman didn't correct them, and he wouldn't have corrected them, because he told -- his belief was 4 p.m. was the deadline.

So, last piece of this is, right, even on the timeline they put up, it looks like it's around 2:00, 2:10 that they've got the script. They're ready to go. And we know it wasn't -- the 15th wasn't the first time they thought about this. They'd been thinking about this since September 8th, thinking about it some more over the weekend. And yet they go out at 3:20 and they ask for quotes at 4

p.m.

It's Lehman Monday. They know because they've been on the phone with dealers doing replacement trades. They've been actually doing replacement trades on the 15th. They know dealers are busy. They send over these spreadsheets. As far as we can tell, there's no real follow-up to say, "Hey, will you give us a price?" There's no genuine effort to obtain market quotes.

THE COURT: So, there was no -- they didn't work the phones on the 16th?

MR. TAMBE: No. Didn't -- and they -- it seems to us they were perfectly content letting market quotation fail so they could then do what they needed to do to value these trades. And what they did, in our opinion, is they inflated the values, they added on charges that no dealer would add on, and you have all these hypothetical prices coming up that doesn't reflect their actual total losses and cost. And, before you know it, you're at $265 million being demanded from the estate.

The other thing you heard a fair amount about in the brief and today was this notion of a clear market quotation hierarchy. Contemporaneous evidence that a hierarchy was actually present and was discussed with the traders, was followed, is lacking.

There's no -- and so, why create this fiction of a

hierarchy? Because it gives a sense of regularity and due regard to following some methodology. And we'll go through this when we examine their witnesses, when they tell you how they value --

THE COURT: But you concede the first two levels of the hierarchy. I mean, everybody agrees that, if market quotation succeeded --

MR. TAMBE: Yeah.

THE COURT: That's what we use.

MR. TAMBE: Yeah.

THE COURT: I think you also conceded that -- and you're not challenging trades they actually replaced.

MR. TAMBE: Mm hmm.

THE COURT: So, Points 1 and 2 of the hierarchy are conceded, right?

MR. TAMBE: Right. Right. And then you get to --

THE COURT: And then you get into --

MR. TAMBE: The most rely --

THE COURT: Other stuff.

MR. TAMBE: Right. And, on the other stuff, we'll wait for their witnesses to see what position they're going to take. But we've seen a few different positions being taken as to whether there was some hierarchy or ranking. Or, for example, would they always take quotes they got back? So, they may not have gotten the full three market

quotations. But, if they got back one or two, did they always take them? Did some traders take them and others didn't? Right?

There's a suggestion that there's a regularity to this process and the way it was applied, and we submit to you the evidence will show, when they walk through their valuation and tell you what they did on each position, it's not going to hold up.

THE COURT: Okay.

MR. TAMBE: There may be broad patterns, but the notion that there was a hierarchy that was followed, there was a system, there was a methodology, I don't think is true. So, it's --

THE COURT: Does -- do each of the traders who were tasked with valuing the types of positions that they were in -- does it have to be the case that each of them followed the same methodology, as long as each of them can support the reasonableness of the methodology that they applied on their portfolios?

MR. TAMBE: Well, it depends on whether QVT wants you to believe there was a hierarchy across dealers. And the suggestion is that there was some hierarchy. If they're saying each trader did what he or she -- what he believed was right?

THE COURT: He.

MR. TAMBE: What he believed was right? Well, that's fine. Then there isn't that type of hierarchy, and maybe some had a hierarchy and others didn't.

THE COURT: Okay.

MR. TAMBE: Right? But this notion that there is this overall system to this I don't think is true, and I think it's belied by the evidence when you go through the separate lines and see what happened and when some data was taken and other data was disregarded.

One of the reasons we found the hierarchy explanation interesting was, if you went through this checklist, where you said, "Okay, I'm going to see if I have a market quotation; if I got that, I'm going to use it; if there's a replacement, I'm going to use it; then I'm going to go through the third category," if anyone was actually following that kind of a system of checks, it would not have been 2016 before they realized they have not stopped quotations for 44 trades.

Right? You would have realized, if there was a system and a checklist that said, "Market quotation, yes or no." You didn't even ask for market quotations. They'd have known that day one. They wouldn't have figured that out in 2016. It makes us wonder whether this is an after-the-fact justification for what was otherwise a fairly hurly-burly process with a lot less rigor to it than they

would like you to believe now.

Right? And that goes into your mix of whether this was a reasonable, good faith effort to calculate total losses and cost, or was this something else?

THE COURT: I think, if you're -- if we're done with market quotation?

MR. TAMBE: Yeah.

THE COURT: It would be a good stopping point for us to let the 4:30 folks get into position. And then you folks can take a break, come and sit in the back, and then, as soon as the 4:30 folks are done, we'll get back to it. You don't have to decamp entirely. Just create a little spot for the 4:30 folks. Come on up.

(Recess)

THE COURT: Thank you for giving me the time to take care of that.

MR. TAMBE: We are back into --

THE COURT: Books and records.

MR. TAMBE: -- books and records, but just before we go to books and records, I was reminded that I passed a slide I should have covered.

THE COURT: Okay.

MR. TAMBE: And it's Slide 28. And that's the 44 transactions, Your Honor --

THE COURT: Okay.

MR. TAMBE: -- and only worth noting that that includes CARB, but it includes 32 of these ABX transactions and the ABX is an asset-backed index, and it's really an index of CDS on subprime mortgage securitizations.

THE COURT: Okay.

MR. TAMBE: Okay, but it's a widely-traded product, a liquid product, as is the iTraxx 9, which is another one of these CDX -- CDS indices that's widely traded, an interest rate swaps were as plain vanilla as they get. All we're noting on this slide is that, if you look at this collection of 44 trades, they ultimately get valued at a number that's $28 million dollars higher than the $915 valuation on QVT's books and records.

Okay, going to books and records. Slide 38, please? This recaps how the valuation that underlies the claim, which is the second-to-the-last column from the right, compares to the values we have from QVT of the positions as of the close of business on September 15th, 2008, the values that go into the collateral call that is made the next morning on September 16th. And then at the bottom, you have the difference between that $382 million-dollar claim valuation after you give effect to other collateral, it's the 265 number.

And on Slide 39, that just tells you sort of by bucket where the real changes in value are coming from. So,

a significant, significant change in value is really how they changed their valuation of the PCDS contracts, but there's also a significant change in the single-name CDS. In the single-name CDS. And as we go through sort of, the reasons that underlie the changes, what's driving those changes is just simply a change in midmarket from 9/12 to 9/15, or 9/15 to whatever this new valuation methodology is, or is it something else, right? And that gets -- you get at that when you look at each specific type of trade and what's driving the inflation, and we'll talk about that.

We’ve talked about, generally, the fact that they're a sophisticated hedge fund. They claim to be -- they wanted to build a best in class hedge fund. Mr. Gold as told us, as a fiduciary of the clients' investments, they were obligated to protect the rights of their investors. They have not just the obligation to calculate collateral correctly, they had the right to do that under contract. They had rights under the credit support annex, not simply to accept Lehman's mark. There's a dispute resolution mechanism built into the CSA that says, if you are a party on the other side of our valuation agent, you don’t like the value, you can institute a formal dispute process, and it's a streamlined process that doesn’t get you into litigation, but results in a clarification of what's going on with the valuation of particular positions, transactions, or the

relationship as a whole. Never invoked in the history of this relationship.

And if it mattered, if these were significant liquidity concerns, if there were significant concerns that Lehman was the only game in town that would make these products difficult to value, they had the right and the obligation to their investors to do something about it. they didn't, until Lehman no longer existed, and now it's a completely different game because now, there is no Lehman to push back and say, we're not going to accept that value. We're not going to accept that calculation. The commercial realities that govern overreaching in derivatives transactions, in a sense, go away once you have a default and you have a bankruptcy entity. Then all that remains is this process, where we get an opportunity to evaluate what the claims are based on, are they reasonable, were they done in good faith, but the commercial reality of not wanting to cross a (indiscernible) and you'll hear about that, the check that ordinarily exists in the market where people will not behave unreasonably, and commercial constraints keep a tack on that, that goes away as soon as Lehman (indiscernible)

THE COURT: Was there anything in the documents? I mean, this goes back to where we started the day with the absence of documents, so, was there anything that, bearing

in mind, you know, the visual of where folks were working, et cetera, was there any discussion of this in the documents that -- in emails or, was there anything?

MR. TAMBE: So, I'll give you -- I think I know what the question is going to. If you look at 42, I think there's some -- I'm not sure -- so, tell me if this answers your question. So, what I'm putting up on 42 is some internal analyses that were done, right?

THE COURT: Yeah, that's what I mean.

MR. TAMBE: So, let's build to that, then. If we can just go to 41 for a second, just so -- so, at the inception of each trade, right, the trade gets booked into QVT's systems. And the trades at inception have a zero value. They're priced at market, so you're not in the money or out of the money on day one. At the end of day one, the markets have moved, someone's in the money, someone's out of the money, and that changes day by day, right? And when you calculate the collateral positions, what you're calculating is, if I'm valuing today and today's the termination date, that's what I'm trying to get a picture on, right? Pretty important calculation. So, historically, they'd use marks from Lehman and third party pricing services, right? And it goes into a system called Tyche, T-Y-C-H-E, right? There are -- there's a system called, I think, Mordor, which gen --

THE COURT: Yes, highly amusing, right.

MR. TAMBE: -- which generates margin faults, right? And there's a system called Beardstown that does the month end marks, so there's a system. There are systems in place, not simply to take Lehman's marks and say, that's it, we're done, our obligations to our investors are satisfied, we can go on. So now, let's get to 42. So, we look through and you see, okay, what kind of comments are you seeing in the comment field there? So, April 30th, 2008. This is with respect to PCDS. It's a Beardstown file, five-year senior SR at 60, right? May 30th, 2008. Mark versus ten-year sub, this is PCDS. Collateral report works out to about 23010 recovery, reasonable since sub-ten year is 185.

Few things that come out from this, right? They're not simply accepting Lehman's marks and saying, that's it, we don't know what's behind it. They're comparing it to something and making themselves comfortable that they can go into their books and records, be part of the nav, and look what they're looking at. Five-year senior. Ten-year subs, right? There is something they're looking at, as a frame of reference.

They're looking at the senior securities, the subordinated securities and CDS on those positions, which, by the way, in the PCDS pamphlet or publication that they got from Lehman at the outset, are some of the things that

were said, hey, that's something you should look at the relationship between PCDS and CDS on senior versus sub, right? And you see them tracking that kind of data. We don't see this type of analysis after the fact. After the fact, it's just one thing and one thing alone that they look at, and they do the most simplistic calculation, 100 minus whatever the bond is trading at, the preferred security is trading at.

And not any preferred security, the cheapest to deliver security, so the lowest priced security on the lowest priced day. So, not all the check or the cross-check that they had back in the day to say, well, that's really what we should be looking at, that's really what drives this analysis.

So, when we look at the books and records, we say, well, where is the loss, right? We have the 9/15 -- where's the beef? Where's the loss? 9/15 is, they have a value. As of 9/30, the trades have been removed from the trading book and the testimony, and I think the documents support this, is there's a booking that's done where, effectively, the value of the trades is offset against the collateral that's being held. Very close. There may be a few million here and there, but it's -- effectively, it's a zero. There's no trading loss as a result of that, or there's a minimal trading loss because of the replacement cost. Not $260

million dollars of trading loss, right? So, as far as the trading book where these trades have resided, since inception, 'til the time they left, there isn't any evidence of a material loss in that book. Trades leave that book, they show up in the side pocket, at a value of zero.

And I don’t believe we have seen any documentation from QVT saying the value of those trades, telling their investors, we believe the value of those trades, forget about the discount on Lehman claims and all that other stuff. The question you asked, I believe, Your Honor. What's your assessment of what's the value of the trade? What's your loss? No such disclosure made to investors in the side pocket, no such disclosure made to investors in the original funds. They -- investors, these positions, leave the funds effectively flat. No loss.

And what you have now is a side pocket where, assuming you start at zero, somebody, either by resolution or by judgment, there's going to be a claim. We recognized, there will be a claim. We're not arguing for a zero claim here, we're not arguing for a receivable. We know there is a claim. Got to be a positive value to that account that holds these transactions. And the folks who will benefit from that include substantially, a number of people who will testify before you, and their interests in those returns have been increasing over time, and, depending on where the

fund is, if that is a profit, the two and twenty system kicks in where the gain also feeds fees of the management team.

So, if they're above their high water mark, that's a profit, that's a gain, the 20 percent of profit kicks in and again, management gets a piece of that. So, what's the point of it? Well, you're going to hear, in the absence of a whole lot of documents, about what people believe they did back then, and what analyses they did back then, distinguished from analyses that have been done more recently, and why they did what they did. Let's not forget, the folks who will be telling you that have an interest, real dollars and cents interest, in making out these claims.

This is the valuation date issue, 45. So, for 500 of the transaction, this is on 46, a little more than 500 of the transaction, I believe, when QVT had their slides up, they have had the number 509. It's roughly 500 transactions. They used data that was post 9/15 data to value those trades, so that's roughly 500 trades, that includes, in that count, PCDS, which is valued using post 9/15 data. It includes CARB, which is valued using post 9/15 data because they used the move for the entire week, 9/15 through 9/19 on GMAC to value that, but it also includes trades that were valued using Markit prices.

And our point is quite simple. The contract

requires the valuation to be as of the termination date. If you're valuing these positions using data after the early termination date when similar data was available, it was reasonably practicable to do this calculation using 9/15 data, you can't claim 9/1t6, 9/17, 9/18 prices and values as your loss as of the early termination date. Because what's necessarily included in those prices are things that happened after you terminated. And there were lots of things happening that week. There were other financial institutions getting in trouble, there were talks of government bailout or no bailout, there was other distress in the market, and that is all reflected in these prices. If you have prices from 9/15, if it's reasonably practicable to do the calculation as of 9/15, they need to do it as of 9/15.

For this population of trades, so this is not the 500, this is a smaller population, using dates other than 9/15 increases the claim by $13.6 million. Just that part of it, not the add-ons and anything. And we'll talk about the date issue specifically on CARB and PCDS because that's a different flavor of date issue. It's not the Markit flavor. Let's get to charges. There clearly were trades that -- transactions that QVT as ones they intended to replace, which to replace, and did replace. Do you need another copy of that because (indiscernible).

THE COURT: It's come undone, but that's okay. I'm -- unless it bothers you, I'm good.

MR. TAMBE: No (indiscernible). They do have numbers at the bottom, so I'm --

THE COURT: Yeah.

MR. TAMBE: -- I'm good.

THE COURT: You're on 50.

MR. TAMBE: They identified what they wanted to replace and they went about replacing them, starting as early as, I think 5:00 or 6:00 in the morning on the 15th, well before they delivered the termination notice. And we think the evidence will show that the trades they didn’t replace, they chose not to replace, because the price of protection had gone up. You've terminated your trade with Lehman. The price of protection has gone up. The protection may look valuable at a lower price, but at the higher price, you might say, I don't know if these companies are actually going to default. If I hold a CDS, I could hold it for five years and pay coupons, a higher rate of coupon, and there could be no default. So, they made a decision. We don’t see evidence, we don’t see a documentary trail where they are pursuing replacement transactions with any type of figure, right? I think you can safely conclude, they replaced what they wished to replace, and they chose not to replace what they didn’t feel like replacing because

the price of protection had gone up after the Lehman default. And after the termination, more importantly.

If you look just --

THE COURT: But if they're entitled to replicate the economics of the position that terminated, why does that matter? Why aren’t they entitled -- right? Why aren’t they entitled to say that, we're entitled to be in the position we would have been in, but for Lehman's default, and therefore, so what?

MR. TAMBE: So, let's talk about that, right?

THE COURT: Okay.

MR. TAMBE: Because the definition of loss doesn’t say replacement value.

THE COURT: Right.

MR. TAMBE: It says loss of bargain.

THE COURT: Right.

MR. TAMBE: And this gets you into discussion of what, exactly, is the bargain when you're holding a CDS or an interest rate swap, or any other instrument? On any given day, it's the present value of that stream of payments. If there is no termination, and if you look at market quotation and you look in other parts of the contract, one of the things you're trying to say is, trying to value is, what would happen to this contract if it had not been terminated? What payments would have been

exchanged between the parties? That's a mid-market number. That's a mid-market number. It's a present value of two cash flows. How much am I paying out for the remaining life of this deal, and what am I expecting to receive on the other side of the swap? That's a mid-market number. That's the bargain. That's all it is.

Now, if you actually go out and replace, under loss, you can say, yeah, I have total losses and costs, and I've incurred the cost. After incurring that cost and paying a dealer the bid-ask spread, I still get just the present value of the cash flows. I don’t get the profit that goes to the dealer. That's the dealer's profit, not mine. That's not their loss or their cost. And that's why, when you look at the values that Lehman's experts have come up with, what they said is, look, if you're doing a replacement value, if you do it properly, this is the kind of result you could obtain. I want to be quite clear to say as a legal matter, we're saying it's a decision for you to make, and it may well be a decision of first impression, but based on the plain language of the loss definition, that if you didn’t incur those costs and expenses, they're not your losses and costs. You do get the benefit of your bargain, you get the mark-to-market and that moved in your favor, you get the benefit of that through the termination date, but not after the termination date. They get to keep the

collateral, $117 million dollars of collateral they're holding, and they get more, but they don't get more than what they actually incurred.

So, let's go to the bid-ask spread discussion. There was an extended discussion about ten percent, it's really a range of three to fifteen, and that there was this finely-attenuated analysis that was done. Is it an on-the-run contract, is not an on-the-run contract. I think there was an American Airlines page that you saw with all sorts of different (indiscernible). Well, let's look at 52. That's an actual list of names from this transaction, set of transactions. VC, which I think is Visteon Corp, and it's a same -- it's the same issuer, and then you have different maturities, and I think Mr. Brunn or Mr. Chu is going to tell you how to read those definitions, so if you read the first line on Page 52, 09 03 20, I think that's a CDS that's expiring on March 20th, 2009, okay? And there's a DS1 and a DS1Q, and I believe what that is, is the first trade is the QVT trade and the second trade is the Quintessence trade, okay? So, you have pairs of transactions moving there.

You will see different quantities, different maturities, exactly the same bid mid adjustment. So, when you actually examine what traders did with particular names in this portfolio, you don't see this rational, methodical process where distinctions are being made for maturity and

size of trade. Sometimes they are, sometimes they're not. and with respect to the ten percent bid mid adjustment, which is a 20 percent bid-ask spread, our view is, that's entirely arbitrary and far too large, and we'll talk about why we believe that to be the case with respect to the vast majority of these charges that are added on, and in many instances, these are added on not to the 9/15 values, but to the 9/16 values. So, the mid-market has already moved up, and they're asking for a 10 percent cushion above that change in the mid-market.

This is a graph from one of their reports, and what they are showing you, Your Honor, is spread data. And I believe this is Figure 7 in Professor Pfleiderer rebuttal report. And you say, wow, the world really fell off a cliff, didn’t it? And your eyes are naturally drawn to the high point in that graph. And you might be thinking, that high point's got to be 9/15. That's got to be 9/15. That's got to be when the world nearly ended. That’s when things came to a halt and no one knew what to do. They don’t tell you where 9/15 is on that graph, so let's start with that. Let's turn to 54. That's where 9/15 is on that graph. It's not the best of times, but it's not the worst of times. Things got a lot worse after 9/15, and we've talked about these folks who were doing the calculation and looking at the move in the markets after 9/15. That's what they were

seeing. They've terminated, they've elected to terminate on 9/15, and the markets have moved. These are composites, financials and others.

So, now we know where 9/15 is on this, and we can drill down a little bit more and say, where exactly, in that September time period -- this is all Professor Pfleiderer's data, by the way. Where, exactly, in that timeframe is 9/15? Oh, there it is. It's before that big spike. It's after a bump up, but it's before that big spike. And right after that big spike, the spreads come right back down. But they picked 9/16 to value the vast majority of their market transactions. They were sitting out in October, they submitted the calculation statement on October 15th, they see this pattern, they pick 9/16 for the vast majority of the Markit transactions.

Let's look at the left-hand scale. That's important. So, going back to things I learned from Danny Connor, let's look at the left-hand scale on Slide 53. Remember when we talked about a 10 percent bid mid adjustment? That's not telling you anything about that. You think it is, but it's not. It's only telling you the absolute spread number.

THE COURT: It's a bid-ask.

MR. TAMBE: It's -- no, not even the bid-ask. It's the absolute spread. How did spreads widen?

THE COURT: So, you'll have to explain this. So, this says -- this says it's the bid-ask.

MR. TAMBE: Yeah, but not in percentage terms. It's in absolute terms, in points.

THE COURT: Ah.

MR. TAMBE: The adjustment they made was at 10 percent of par. It was a percentage adjustment they were making, not an absolute adjustment.

THE COURT: Right.

MR. TAMBE: You look at this and you see 100 and 125, 75, you see these big numbers out here. They're talking about absolute point spreads, not percentage point spreads.

THE COURT: Okay. So, you're going to give me a chart that shows it?

MR. TAMBE: Yup. Well, see Professor Pfleiderer could have given you that chart because that's his data on 56. He picked the column that has the absolute numbers, the bid-ask 15.81, for example, in the first row?

THE COURT: Yeah. Yep.

MR. TAMBE: He had the data that allowed him to compare a percentage bid-ask to mid. So, that's the bid-ask spread in percentage terms, compared to the mid. So again, it's the full bid-ask spread, but in percentage terms. It's still not the bid mid. The bid mid would be half of that,

right? So, he has data in his data set, and this is just the September data set. He had the data set going back, I think to 2007 all the way through the end of 2008. So, he has that in his possession, but the chart he shows you is falling off the cliff, right? It's the chart you see from Professor Pfleiderer is 53. You don’t see this data and what this data drive is 57.

That's what's really happening to bid mid spread as a percentage of CARB in that bid set. They're going down. That might astound you. But they're going down the percentage of the overall spread because the overall spread is increasing. They're getting the benefit of that when they get the mids. The mids show them that they're getting the benefit of that rising spread market, right? But this is what the data is showing about the spreads as a percentage of par, and again, you could dive deeper into the data, so you're looking at September and October of 2008, and again, it's higher after the 15th, right, and then it declines later on in the month. But they're sitting out in October 15th, and they look back, and they say, no, we're just going to take a 10 percent bid mid adjustment, okay? Double what's shown by this data from Professor Pfleiderer.

All right, so let's talk about some of the specific valuations.

THE COURT: Let's decide if we're going to keep

going if we're going to call it a night. I think it might be a good idea before we get into CARB valuations, which looks like it's got a fair number of slides, to call it a night, so.

MR. TAMBE: That would be (indiscernible).

THE COURT: You still have a number of tabs to go.

MR. TAMBE: Yep.

THE COURT: What do you think in terms of how much longer you have tomorrow, Mr. Tambe? I've lost track of how long you've been speaking, to be honest.

MR. TAMBE: About 15 minutes, no -- I'll have, I think, an hour to go.

THE COURT: Okay.

MR. TAMBE: I think.

THE COURT: So, that's good. So, excuse me, we'll start at 10:00, you'll finish at 11:00, we'll take a brief break, and then who are we going to hear from in terms of a witness, Mr. Tracey?

MR. TRACEY: The first witness will be Nick Brunn.

THE COURT: Okay.

MR. TRACEY: He'll be ready to go any time tomorrow.

THE COURT: Okay.

MR. TRACEY: I think one thing we left open was the one and done issue. I don't know that we ever decided

that. I think --

THE COURT: I think we agreed that it was going to be one and done -- we were going to call one and done on each witness before they started, so that's for you two to discuss --

MR. TRACEY: Okay, so we'll -- we'll need to talk about that

THE COURT: -- and then let me know so that I know what we're doing in terms of the scope. Is that too short-hand? Everybody knows --

MR. TRACEY: No, that's fine.

THE COURT: -- what're talking about?

MR. TRACEY: Sure.

THE COURT: Okay.

MR. TAMBE: Can I have (indiscernible) request, Your Honor?

THE COURT: Yeah. I'm just trying to think if I have any other matters that I'm squeezing in tomorrow. I don't think so. Okay, go ahead.

MR. TAMBE: What we anticipate is, there's going to be a series of fact witnesses who will talk about specific parts of the valuation.

THE COURT: Right.

MR. TAMBE: It would be helpful to know, even if we know the night before, if a witness is -- what specific

line items or product types the witness will talk about?

THE COURT: Well, that's what -- when I talked to Mr. Tracey about the buckets, the schematic, that's what I wanted to know ahead of time so that I -- if there's going to be -- if a particular witness is going to testify across different products versus only talking about CARB versus -- but don’t you know that from --

MR. TRACEY: We've had so many depositions, they know that.

THE COURT: Okay. All right.

MR. TRACEY: Yeah.

THE COURT: So, you don't know -- you don’t necessarily know?

MR. TAMBE: We don’t necessarily know, that's the issue.

THE COURT: Okay.

MR. TAMBE: So, I expect -- I fully expect Mr. Chu to address PCDS and CARB, okay? I expect that. But if someone else is going to address PCDS and CARB, I'd like to know that before that someone gets on the stands because part of what we're going to be doing, no surprises, with the fact witnesses is, we're going to be walking through some spreadsheets, and that's laborious, and that requires us to do some prep in terms of the examples we want to show you --

THE COURT: Okay.

MR. TAMBE: -- with the fact witness. So that's -- we just want a little heads up --

THE COURT: Okay, I'm sure they'll give it to you.

MR. TRACEY: Of course.

THE COURT: So --

MR. TAMBE: You don’t expect Mr. Brunn to talk about any specific line items? That's our expectation based on the role he played. Is that a fair --

MR. TRACEY: That is. Mr. Brunn did not personally value any positions, so, he's not going to be presenting any testimony about valuations (indiscernible) positions.

THE COURT: Okay.

MR. TAMBE: That's all.

THE COURT: All right, in terms of expectations for tomorrow, tomorrow we're only going to go to 5:00. I actually have to do a -- teach a class tomorrow night on Brazilian and Mexican bankruptcy law. Why not? So --

MR. TRACEY: And you have a lot of time to prepare for that, Your Honor.

THE COURT: Already done. So it'll only be until 5:00 tomorrow night so that I can get to where I need to be, all right? Thank you very much. You can obviously leave your stuff where it is, just tidy up, and I will just ask you to throw away any spare water bottles that you have.

Thanks very much.

MR. TAMBE: Thank you, Your Honor.

MR. TRACEY: Thank you, Your Honor.

THE COURT: Thanks, Matt.

(Whereupon these proceedings were concluded at 5:50 PM)

C E R T I F I C A T I O N

I, Sonya Ledanski Hyde, certified that the foregoing transcript is a true and accurate record of the proceedings.

Sonya
Ledanski Hyde

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